FSM ECONOMIC REVIEW

Federated States of Micronesia

May 2025

Graduate School USA

EconMAP

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
AIP	—	Annual Implementation Plan
BGRT	—	Business Gross Receipts Tax
C-03	—	The 2003 amended Compact
C-23	—	The 2023 amended Compact
CARES	—	Coronavirus Aid, Relief, and Economic Security Act
CDA	—	Coconut Development Authority
CFC	—	Caroline Fisheries Corporation
COFA	—	Compact of Free Association
COVID	—	Coronavirus Disease
CPI	—	Consumer Price Index
CPRO	—	Coronavirus Pandemic Relief Option
CTF	—	Compact Trust Fund
DAEF	—	Disaster Assistance Emergency Fund
DBS	—	Doing Business Survey (World Bank)
DOFA	—	Department of Finance and Administration
DSA	—	Debt Sustainability Analysis
FAA	—	Federal Aviation Authority
FAS	—	Freely Associated States
FDI	—	Foreign Direct Investment
FDIC	—	Federal Deposit Insurance Corporation
FMIS	—	Financial Management Information System
FPA	—	Fiscal Procedures Agreement
FSM	—	Federated States of Micronesia
FSMTC	—	FSM Telecommunications Corporation
FSMTF	—	FSM Trust Fund
GDP	—	Gross Domestic Product
GFC	—	Global Financial Crisis
GFS	—	Government Finance Statistics
GSUSA	—	Graduate School USA
ICT	—	Information and Communication Technology
IDP	—	Infrastructure Development Plan
IPP		Independent Power Producer
IMF	—	International Monetary Fund
JEMCO	—	Joint Economic Management Committee
MTEF	—	Medium-Term Expenditure Framework
NORMA	—	National Oceanic Resource Management
OAE	—	Open Access Entity
OECD	—	Organization for Economic Cooperation and Development
OIA	—	Office of Insular Affairs
PAE	—	Part Allowable Effort
PEFA	—	Public Expenditure and Financial Accountability
PFM	—	Public Financial Management
PFMRR	—	Public Financial Management Reform Roadmap
PFTAC	—	Pacific Financial Technical Assistance Center

PNA	—	Parties to the Nauru Agreement
PNG	—	Papua New Guinea
PSDI	—	Private Sector Development Initiative
PSRP	—	Public Sector Reform Program
PUC	—	Pohnpei Utilities Corporation
RFP	—	Request for Proposals
RMI	—	Republic of the Marshall Islands
RMS	—	Revenue Management System
SAFER	—	Sustainability Adjustment for Enhanced Reliability
SDP	—	Strategic Development Plan
SEG	—	Supplemental Education Grant
SME	—	Small Medium Size Enterprises
SOE	—	State-Owned Enterprise
SSA	—	Social Security Administration
TFA	—	Trust Fund Agreement
USA	—	United States of America
VAT	—	Value Added Tax
VDS	—	Vessel Day Scheme

NOTE:

1. The FSM government fiscal year (FY) ends on September 30.
2. Figures in the report are subject to rounding.

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Disclaimer

The views, thoughts, and opinions expressed in this economic review are those of the authors and represent an independent assessment of the economic performance of the Federated States of Micronesia. This document does not necessarily represent the views of the State governments or National Government of the Federated States of Micronesia, the Graduate School USA, the US Department of the Interior, or any other organization, committee, sponsor, group, or individual.

Foreword

This Economic Review, produced for the Federated States of Micronesia, aims to support the FSM in implementing the renewed economic assistance under the 2023 Amended Compact, enacted in legislation by the U.S. Congress and passed into law by the US President in March 2024. This review has also been designed to assist the FSM in overall policy and economic management. It has been developed under contract with the US Department of the Interior's Office of Insular Affairs (OIA) and administered through the Graduate School USA's Pacific Islands Training Initiative. The review is intended to assess the FSM's economic performance and policy environment and to present a comprehensive set of economic statistics.

This Review was prepared in early 2025 with preliminary economic data covering FY22, and the fiscal accounts based on the FY24 Financial Management Information System. Initial economic data for FY23 were prepared using a combination of actual outcomes and estimates for missing data sources, mainly industry GDP.

On behalf of Graduate School USA and EconMAP (Economic Monitoring and Analysis Program), the review was authored by Mark Sturton; Michael Barsabal and Glenn McKinlay compiled the statistical data set. Additional input was received from Emil Friberg, Kevin O'Keefe, and Jason Aubuchon. Special thanks are extended to: Hon. Elina Akinaga, Secretary of Resources and Development; Brihmer Johnson, Assistance Secretary of the Statistics Office in R&D; Sharon Pelep; and the many

civil servants and business operators from the FSM who supported the preparation of this review and its statistical tables.

A digital copy of this review is available online at http://www.econmap.org.

Key Features in the Review

The 2023 Population Census of the Federated States of Micronesia (FSM) reveals significant depopulation and out-migration. Initial estimates from the 2023 census show a significant decrease in population compared to 2010 levels, falling well below earlier projections. While out-migration had been anticipated to be substantial, the extent of depopulation has far exceeded expectations. The Republic of the Marshall Islands experienced a 20 percent population decline from 53,000 in 2010 to 42,000 in 2021. In the FSM, preliminary estimates suggest an even larger reduction of 25 percent. Although the FSM is working to validate these results, delays have been significant. Given the similar population trends in other Micronesian nations, preliminary data should be made public, with appropriate caveats.

Economic growth during the 2003 Amended Compact (C-03) period has been disappointing. The average GDP growth rate during this period was only 0.3 percent, with GDP rising by just 5 percent from FY03. At the start of the amended Compact, the economy had to adjust to a reduced level of Compact sector grants, establishing a new baseline. This was followed by a rapid period of construction growth driven by FAA airport-improvement projects and increased use of the infrastructure grant. However, once these FAA projects concluded and the infrastructure grant was put on hold, the economy faced a sharp contraction. During the latter part of C-03, leading up to the COVID-19 pandemic, the economy saw some expansion, largely fueled by booming sovereign rents.

The FSM economy is estimated to have contracted by 2.0 percent during the COVID-19 period from FY19 to FY22. Initial analyses indicated that GDP could decline by as much as 7 percent over the FY20-FY22 period. However, recent national accounts estimates show a more nuanced picture: after a 1.8 percent contraction in FY20, the economy grew by 3.0 percent in FY21, only to contract by 3.1 percent in FY22. The large inflow of aid to mitigate the health and economic impacts of the pandemic helped cushion the overall effect, significantly reducing the economic downturn.

Economic performance at the state level has been uneven, with growth in Pohnpei but decline in the other states. During the 2003 Amended Compact (C-03) period, Pohnpei State experienced an average annual growth rate of 1.4 percent. In contrast, the other three states—Chuuk, Kosrae, and Yap—saw declines in economic activity, with respective decreases of 0.6, 0.2, and 0.5 percent. Pohnpei's growth was driven by its status as the seat of the National Government, as well as a rapid increase in sovereign rents and associated National Government expenditures. The other states, however, faced declining Compact funding, and their limited fiscal capacity restricted growth and development. The new 2023 Amended Compact (C-23), along with changes in provisions for fishing fee royalties, is expected to alter this dynamic. State governments will now receive increased levels of Compact revenues and fishing fee royalties, which should boost State GDP levels.

Trends in employment during the C-03 period have been disappointing, with a net loss of 1,100 jobs. Total employment in the FSM economy declined by 1,100 jobs, or 7 percent of the FY04 labor force, during C-03. Both the private and public sectors experienced similar declines, at 8 and 10 percent, respectively, though non-profits, households, and foreign missions helped offset some of the loss. This outcome is clearly disappointing, as it indicates that the FSM has struggled to create enough job opportunities to retain its population. While final population census data has not yet been released, the anticipated decline in population is not unexpected, given the economy's inability to generate new employment opportunities.

After a period of modest inflation during the COVID era, inflation surged by 18 percent between FY21 and FY24. Inflation remained relatively modest during the early years of the pandemic, with prices rising by only 2.8 percent from FY19 to FY21. However, as the global economy began recovering from COVID, factors such as global supply shortages, expansionary fiscal policies, and the Ukraine war led to high global inflation. In the FSM, the increase in prices was concentrated in food, fuel, and restaurant prices, which rose by 27 percent, 26 percent, and 34 percent, respectively. Other items experienced a more moderate increase, with prices rising by an average of 7.0 percent.

The implementation of the Vessel Day Scheme has led to rapid growth in fishing fees, but the provisions of the FSM arrangement have limited the potential benefits. Regional fisheries are primarily governed by the Parties to the Nauru Agreement (PNA), which has resulted in a substantial and sustained increase in member country revenues from the sale of vessel days—an increase of five times for the FSM since the start of the 2003 Amended Compact. In FY23, the FSM received $72 million in fishing revenues, which represented 16 percent of its estimated GDP. However, the introduction of the FSM arrangement, a regional facility, has led to large discounts that are justified as a means to encourage local economic development. While two local companies make a solid contribution to the FSM economy, a significant number of purse seiners—34 vessels—are domestically flagged but contribute minimally to the local economy. This review estimates a potential loss of $22 million. Although this figure is indicative only, a transparent evaluation is needed to allow the public and the FSM government to make informed, evidence-based decisions about whether the discounts are justified by their costs.

Prior to the recent changes in revenue sharing, the National Government consistently ran large fiscal surpluses, while state governments faced challenges in maintaining fiscal balance. These discrepancies between State and National fiscal outcomes have raised concerns for some time. Between FY14 and FY22, the National Government's fiscal surplus averaged 12.4 percent of GDP, while state governments had a small average fiscal balance of 0.3 percent of GDP. State governments, which are responsible for service delivery, particularly in the social sectors of health and education, have been severely constrained by the decline in the real value of Compact sector grants.

The recent plebiscite to amend the FSM constitution has significantly changed the distribution of revenues, expenditures, and fiscal balance in the FSM. In response to concerns about the lack of equity between the National and State governments, a constitutional convention and plebiscite were held in July 2023 to amend the constitution and allocate fishing fee revenues equally between the National and State governments. The electorate approved the proposed change, which became part of the revenue-sharing arrangements for FY23. In reaction, the National Government repealed several laws that had previously earmarked resources for the states and mandated contributions to the FSM Trust Fund. As a result, state expenditures and fiscal surpluses increased in FY23 and FY24, while the National Government's fiscal position turned negative due to lost revenues, rising operational expenses, and congressional districts legislative projects.

The FSM has transitioned from "grant-only" status to a new arrangement that blends 50 percent grants and 50 percent loans. In 2013, the IMF and World Bank conducted a Debt Sustainability Analysis of the FSM economy, which identified the country as being at risk of high fiscal stress. While debt levels were low at that time, the potential impact of failing to renew the Compact with the U.S. in 2024 was seen as a significant risk, potentially leading to unsustainable external debt. As a result, the FSM's multilateral partners placed the country on "grant-only status." However, following the successful renewal of the Compact in 2024, the FSM is no longer considered at risk of high debt stress, and it has lost this "grant-only" status with its multilateral partners. Instead, the new funding arrangement involves a balanced mix of 50 percent grants and 50 percent loans.

The creation of the FSM domicile for Japanese corporations has led to significant inflows of resources. In 2005, the FSM passed corporate tax legislation that established an overseas domicile, generating a steadily growing stream of revenues for the National Government. In FY18, the FSM saw an unusually large receipt of $84 million. This was followed by substantial payments of $62 million in FY19 and $59 million in FY21. While large payments are expected periodically, these amounts were exceptional. In FY24, corporate tax receipts are expected to return to more typical levels of $11 million.

There is a need to replicate the recent national-level Public Financial Management (PFM) reforms at the state levels. Over the past 15 years, the National Government has conducted Public Expenditure and Financial Accountability (PEFA) assessments, developed PFM roadmaps, and recently benefited from technical assistance (TA) support. With changes in the national fiscal environment, there is an increasing need for efficiency improvements in public service delivery. However, the most pressing need is at the state levels, where the majority of services are delivered and where PFM analysis and reforms have been lacking. Initially, a set of state-level PEFAs would be required, followed by the development of state-specific PFM roadmaps. Achieving this would require both strong commitment at the state level and significant TA support.

The recently issued Strategic Development Plan (SDP) lacks a comprehensive framework for development and planning. While the SDP outlines high-level objectives, it does not provide a structure for annual budget preparation, implementation, or monitoring. Additionally, it does not include a macroeconomic framework that outlines various development goals and potential paths for the FSM over the next 20 years. Developing such a framework will require, much like the comprehensive SDP of 2003, substantial donor support and active stakeholder participation. The 2003 SDP process culminated in the third FSM economic summit, which was attended by a broad group of stakeholders from all levels of society and the FSM states, setting the stage for the country's development under the 2003 Amended Compact.

State-Owned Enterprise (SOE) performance in the FSM has been mixed and lacks a cohesive, guiding framework. While the SOE sector has posed less fiscal risk compared to the FSM's sister Micronesian states, significant weaknesses remain. Pohnpei utilities have faced legislated restrictions that prevent the adoption of an efficient pricing regime. FSM Telecom has implemented policies that duplicate infrastructure and conflict with the national ICT policy. Meanwhile, PetroCorp has undertaken the objective of supporting a struggling copra sector, exacerbated by labor shortages from large out-migration, aging coconut trees, and other adverse factors. Due to a lack of sufficient information on cross-subsidization in the audits, this has likely contributed to a decline in PetroCorp's profitability. These issues suggest that the FSM should consider adopting a comprehensive SOE framework that clearly defines the sector's objectives, including commercialization, community service obligations, and critical governance reforms.

The signing of the 2023 Amended Compact into law in March 2024 brings increased resources but also significant increases in reporting. As a result of Amended Compact, annual sector grants will rise from the current level of $100 million (including the Supplemental Education Grant) to $140 million. Federal grants and services will continue, along with the Joint Economic Management Committee (JEMCO). Unlike the Republic of the Marshall Islands (RMI) and Palau, the FSM's Compact does not include an annual 2 percent adjustor. Instead, the FSM will receive an additional $500 million injection into the Compact Trust Fund. The 2023 Amended Compact also provides for continued economic assistance beyond FY43, though the provisions for the adjustor after this period remain unclear. While the role of JEMCO has expanded, its focus has shifted from ex-ante grant approval to ex-post monitoring. In addition, there are now several annual reporting requirements, including (i) the strategic development plan, (ii) the infrastructure development plan, (iii) annual implementation plans, (iv) financial reports (both annual and quarterly), and (v) performance reports.

The FSM has adopted a policy to allow the Compact Trust Fund (CTF) to accumulate through the C-23 period, but it will not be sufficient to support the current real level of annual distributions with a high degree of certainty. By the end of C-03, the CTF had reached a value of $1.071 billion. While this level of the CTF corpus was considered inadequate to replace the FY23 level of Compact sector grants, the FSM decided, with the renewal of the Compact, to forgo distributions from the CTF (except for annual withdrawals to adjust for inflation) and allow the fund to accumulate through FY43. By that time, the CTF is expected to support withdrawals equivalent to the inflation-adjusted level of FY24 Compact sector grants, totaling $140 million, based on average historical market rates of return. However, it will not be sufficient to accommodate market risk with a high degree of certainty.

A large fiscal surplus at the National Government has supported rapid growth in the nation's FSM Trust Fund (FSMTF). In the early years of C-03, the FSM established the

FSMTF to provide an additional source of funds for the nation after the anticipated expiration of the annual sector grants in FY23. Initially, the fund grew slowly, but with the influx of sovereign rents from fishing fees and the FSM domicile for major Japanese corporations, the National Government allocated a significant portion of its structural surplus to the FSMTF. By the end of November 2024, the FSMTF was estimated at nearly $525 million, marking a significant achievement. The original purpose of the FSMTF was to fund government operations, and given the limitations of the Compact Trust Fund, this remains a key objective. However, the combined resources of both funds should be sufficient to allow for some allocation to other national priorities.

A major issue during C-03 has been the failure to fully utilize the Compact sector grants allocated for infrastructure. Challenges in utilizing these funds stemmed from a series of procurement and management issues between the FSM and US. Out of a total estimated allocation of $457 million for infrastructure since the start of the amended Compact through FY22, the FSM was only able to utilize $152 million, leaving $305 million (74 percent of the allocation) unspent. Under the provisions of C-23, 25 percent of the annual grant stream—equivalent to $35 million—will be allocated to infrastructure, representing a considerable increase over the C-03 provisions. In addition to the unspent funds, a total of $1 billion (in today's prices) will be available throughout the C-23 period. This is a substantial amount of resources that could support the FSM's infrastructure and development while providing a significant boost to demand and economic growth. It is hoped that the issues from the previous period can be addressed, allowing the FSM to fully capitalize on the available resources.

The lack of available national accounts and GDP statistics is a significant concern. From FY00 to FY16, a Memorandum of Understanding (MOU) between the FSM Department of Finance and the Statistics Division of the Department of Resources and Development facilitated the sharing of information, allowing the FSM to develop a series of GDP estimates by industry. However, this arrangement was terminated in FY16, and it wasn't until FY22 that a new MOU was established, enabling the estimation of GDP for the missing period. Unfortunately, this positive development was short-lived, as data sharing was once again halted, and no official GDP statistics have been released since. The absence of GDP figures severely hampers the FSM's ability to monitor economic performance, growth and development, or to formulate effective development plans. Furthermore, the surveillance of the FSM economy by international organizations such as the IMF is at risk. Analyses like the IMF and World Bank's Debt Sustainability Analysis become problematic without reliable debt-to-GDP ratio data. This issue requires urgent resolution.

1. Recent Economic Performance Performance

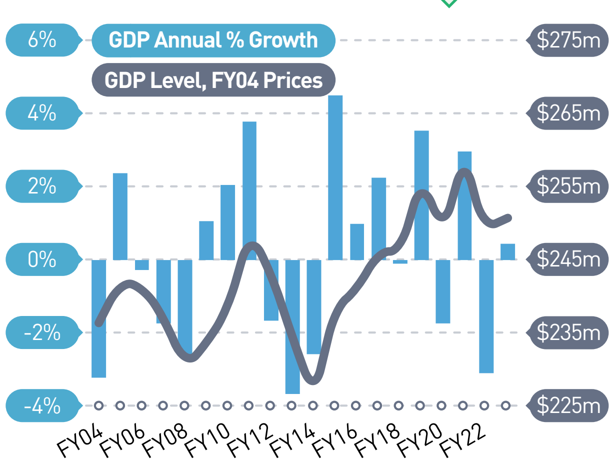
The economy is projected to have fallen by 2.0 percent during COVID, FY19-FY22, and was essentially static if the volatile impact of the fisheries sector is excluded.

Economic performance has been weak and displayed significant volatility during the amended Compact period. The average trend GDP growth during the amended Compact has been weak, averaging 0.3 percent[1], with GDP only 5 percent higher than in FY03, see Figure 1. Growth has also been highly volatile with great fluctuations. At the start of the amended Compact the economy was forced to adapt to the reality of fewer Compact sector grants and fell to a new baseline. This was followed by a period of rapid construction growth, reflecting FAA airport-improvement projects and greater use of the infrastructure grant. When the FAA projects came to a close and as the use of the infrastructure grant was placed on hold due to procurement and contractual issues, the economy went into decline.

1 Long-run trends in this Review use log-linear regression.

Figure 1: GDP level and growth, constant prices FY04

FSM has experienced volatile GDP growth during C-03



In the latter part of the 2010s and before COVID, the economy improved and averaged 2.2 percent annual growth through FY19. The better performance reflected the rapid growth in sovereign rents[2]: fishing royalties and revenue growth from the FSM domicile for large Japanese corporations. The better performance was reflected in growth in two broad areas: (i) financial services and offshore sector, and (ii) greater public expenditure and its impact on the domestic economy. Retail, financial and business services all showed signs of positive growth coupled with growth in public administration. By FY19, the FSM economy had undergone a period of improved performance.

The economic impact of COVID is now estimated to have been modest. The economy is estimated to have declined by 1.8 percent in FY20 at the start of COVID, grown by 3.0 percent in FY21, and fsllen by 3.1 percent in FY22, bringing the total impact of the pandemic to a 2.0 percent decline over the three years. If the volatile impact of commercial fisheries (-2.1 percent) is excluded from this total, the overall impact of COVID during the FY19-FY22 period was essentially negligible. Initial estimates of the impact of COVID had projected an overall decline3 of 5.0 percent of GDP, but

2 Sovereign rents include fishing royalites and earnings from the FSM domicile for Japanese captive insurance and major corporations.

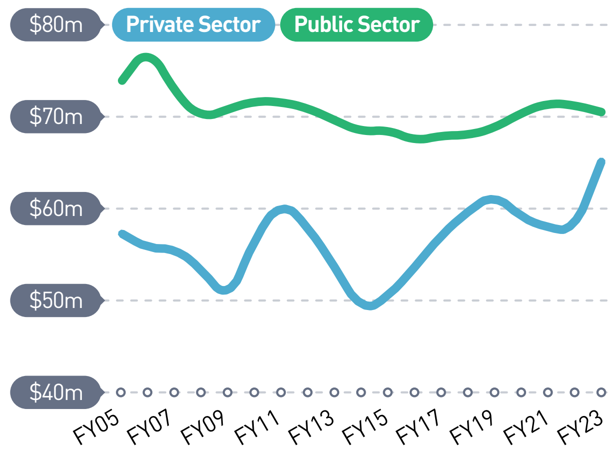
3 Graduate School USA, Economic Brief FSM FY21, October 2021, Honolulu.

as events transpired, they were similar to the normal annual fluctuations in the economy.

The private sector was hardest hit by COVID, but the impact was strongly mitigated by the various FSM and donor support programs. The impact of COVID was mainly focused on the private sector, which contracted by 6.3 percent during FY19-FY22. Conversely the public sector and the provision of public services supported by the various mitigation programs grew by 3.6 percent. Given the small size of the private sector (22 percent) relative to the total economy, the combined impact on GDP over the three-year period was not as great as may have been anticipated. The impact of the various mitigation programs on the economy was significant. The FSM's own economic stimulus program, US health and CARES unemployment benefits, and the ADB COVID Pandemic Relief Option (CPRO), all significantly reduced the impact on the economy. Without these programs, it is estimated that the economy would have contracted by 6.9 percent; that is, the mitigation efforts reduced the contraction by 4.9 percent.

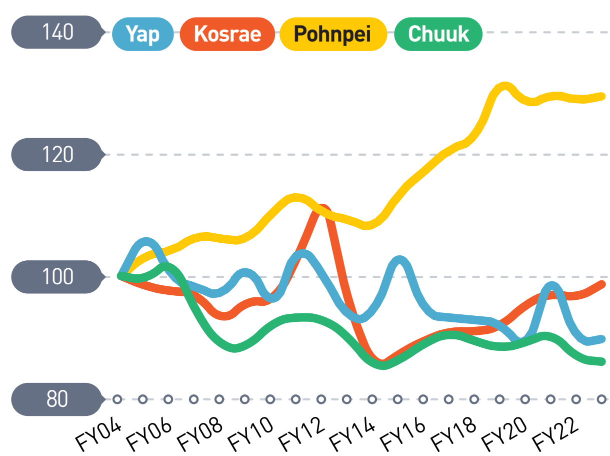
During the 2003 Amended Compac,t the public sector contracted, but the private sector exhibited volatile performance. The public sector experienced a large contraction at the start of C-03 and a gradual decline through FY19, reflecting the tight fiscal conditions at the state level, see Figure 2. During COVID the public sector expanded, as it was funded through the large mitigation programs but declined in FY23 after the end of the pandemic. In early years of C-03, the small, dependent private sector activity contracted in line with the public sector but grew rapidly with the large construction projects in FY09-FY11, and contracted as those projects came to an end. Thereafter the sector performed better with the rapid growth in sovereign rents and public expenditure, but the impact of COVID halted the expansion. In FY23, the private sector recovered from COVID and recorded the highest level since the start of C-03.

Figure 2: GDP Private and Public Sectors, constant prices FY04
Public sector contracts during C-03, while the private displays volatility depending on construction and domestic demand



Economic performance at the state level has been uneven with growth in Pohnpei but decline in the other States. During the C-03 period Pohnpei State has shown sustained improvement in economic activity, growing by an average 1.4 percent per annum, see Figure 3. For the three other states, the economies have declined by 0.6, 0.2 and 0.5 percent,

Figure 3: Economic performance at the state level, FY23 = 100
GDP declines in Chuuk and Yap, remains unchanged in Kosrae and grows by 1.4 percent in Pohnpei during C-03



respectively in Chuuk, Kosrae and Yap. Pohnpei State has benefited from being the seat of the National Government and the recent rapid rise in sovereign rents and National Government expenditures. The three other States have experienced declining Compact flows and the resulting repressed fiscal position constrained growth and development. The new C-23 period together with the change in provisions for fishing fee royalties has changed this dynamic. The state governments will now receive increased levels of Compact revenues and fishing fee royalties, all of which will boost state GDP levels.

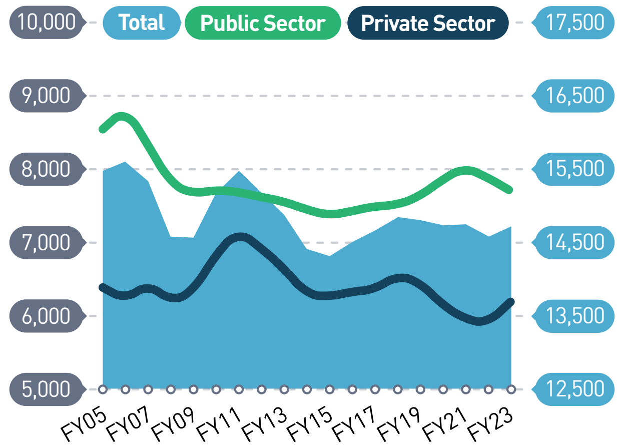
While GDP growth has been modest or declined, GDP per capita has risen. Initial 2023 population census figures have yet to be published although it is known they have declined significantly. Using rates of depopulation for the RMI as a proxy, which are likely to be less than the FSM, it is projected that while GDP growth has been either stagnant or negative, the rise in GDP per capita has been significantly higher. For the FSM as a whole GDP per capita is projected to have risen by 2.2 percent annum, which in normal circumstances would be an acceptable result. By state, this translates into 1.4, 1.9, 2.9, 1.2 percent increase per annum in Chuuk, Kosrae, Pohnpei and Yap, respectively. However, this is a perverse result in that the increase in GDP per capita has been achieved through a decline in population rather than economic growth.

Employment

The FSM underwent a painful downward adjustment in public sector employment at the start of C-03. During FY03-FY08, public sector employment fell by 1,000 jobs, or 11 percent of the total labor force, as the FSM made the painful adjustment to the less favorable terms of the amended Compact, see Figure 4. From FY08 through to FY15, public sector employment continued to gradually decline but from FY15 showed signs of improvement, reflecting the rapid growth in

Figure 4: Employment by industry

Public sector employment growth contracted through much of C-03, as private sector spiked with construction activity



sovereign rents. With the advent of COVID, the size of public-sector employment was boosted through the various mitigation programs, but since FY22 the civil service has gravitated back to pre-COVID levels.

Private sector employment has displayed a volatile pattern of ups and downs. After a relatively stable pattern at the start of the amended Compact, private sector employment grew rapidly during FY08-FY11 with over 1,000 additional jobs created due to construction activity related to large FAA airport improvement projects and enhanced use of the infrastructure grant. In the following years through FY14, the FAA projects wound down and use of the infrastructure grant dried up, and all the previous gains in employment were lost. After FY14 private sector employment started to rebound reflecting both increased demand from fisheries-related activities and booming sovereign rents. In FY20, the onset of

The FSM economy failed to generate jobs during the 2003 Amended Compact and employment fell by 1,100 jobs.

the pandemic resulted in a large reduction in the tourism and transport sectors and by FY22 there had been a loss of 500 jobs, or 9 percent of the private sector labor force. In FY23 as the economy began to recover from the pandemic, private sector employment recorded a 5 percent growth.

Overall trends in employment during C-03 have been disappointing, with a loss of 1,100 jobs over the period. While employment in both the public and private sectors was volatile during C-03, total employment fell by 1,100 jobs or 7 percent of the FY04 labor force. Both the private and public sectors displayed similar declines. This is clearly a very disappointing result, indicating that the FSM has been unable to halt out-migration and generate sufficient jobs to attract people to remain in the country. While the final population census data is yet to be released, the large anticipated decline in the population is not unexpected given the failure in the economy to generate jobs.

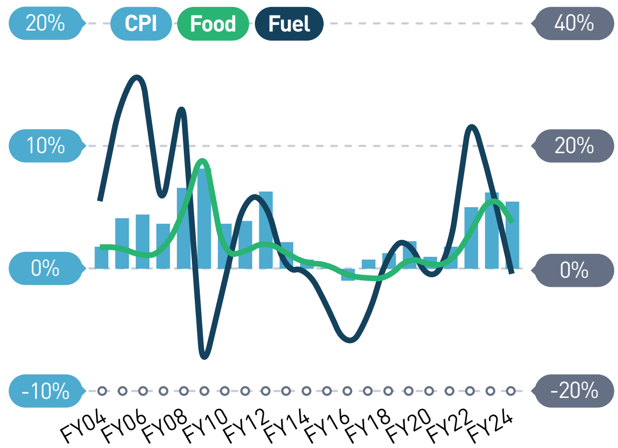
Inflation

Inflation has generally been modest in the FSM with the exception of the Global Financial Crisis and more recently during the post-pandemic recovery period. In the early 2000s inflation in the FSM was modest, but with the advent of the Global Financial Crisis in FY07-FY08, prices rose rapidly, see Figure 5. During the two-year period prices rose by 6.6 and 8.8 or a total of 15 percent. After the crisis dissipated over the next few years, inflation returned to benign rates, recording an average of less than 1 percent annually between FY14 and FY21. Dring the early COVID years inflation was modest, reflecting the slowdown in the global economy, but in FY22 the FSM experienced a surge in inflation due to the same forces affecting the rest of the world. Expansionary fiscal policies enacted during the COVID-19 pandemic, combined with supply shortages as the global economy reopened, drove inflation to levels not seen since the 1970s and 1980s. The Ukraine war further exacerbated the situation, with rapidly rising fuel and food prices pushing inflation in the FSM to 5.8 percent in FY22. These trends continued in FY23 and FY24 and inflation recorded 6.2 and 5.4 percent, respectively.

Reflecting global trends, the FSM underwent a period of rapid inflation during FY22-FY24 with a total increase in prices of 18 percent.

Figure 5: FSM CPI, percent annual change

Inflation spiked in FY22 through FY24 reflecting global trends



The major determinants of inflation in the FSM have been food and fuel prices. In the case of food prices, rapid increases were experienced during both the Global Financial Crisis (GFC) and post-pandemic periods, but in other periods inflation was modest. Given the high weight of food in the FSM CPI, about 45 percent, it is expected that periods of rapid food inflation would have a large impact on the FSM cost of living. Over the C-03 period prices of food items rose at an annual rate of 3.3 percent. In the case of fuel, the FSM experienced many periods of rapid changes; for 11 years out of the 20-year C-03 period, fuel price inflation rose or fell by more than

10 percent. Over the C-03 period, the cost of fuel rose by an average of 5.6 percent per year. However, the weight of fuel in the FSM CPI basket is only 12 percent and far less than food, so despite the volatility of fuel prices, the impact on the cost of living has been less dramatic.

Wages

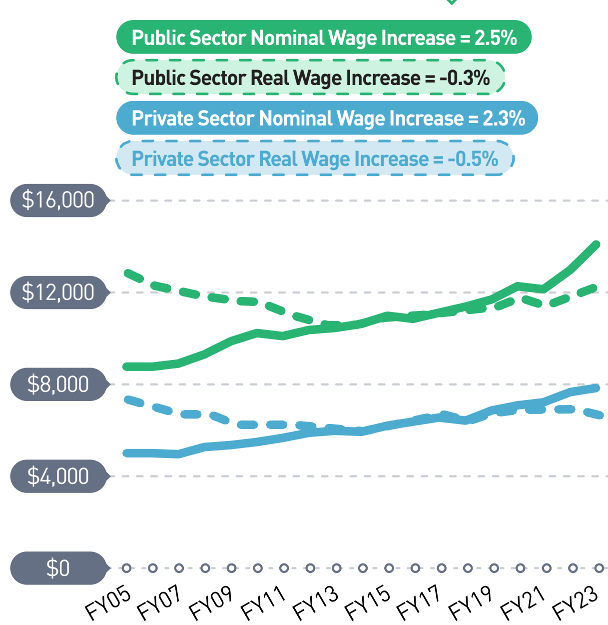
Over the period FY04-FY23, real wages have fallen in both the private and the public sectors. Taking a long-term view of nominal and real wages, Figure 6 describes developments since FY04. Average nominal wages in the private sector have grown by 2.3 percent while those in the public sector grew by an annual average of 2.5 percent. In real terms, real wages have fallen by 0.5 percent and 0.3 percent, respectively. However, these figures represent averages and there have been three distinct periods in wage developments in the FSM.

While real wages fell significantly during the first part of the amended Compact, they rose significantly during FY14-FY21. During the early years of C-03, between FY04 and FY13, which covered the GFC period, nominal wages in both sectors were repressed and failed to keep up with inflation, reflecting the tight financial conditions facing the FSM. Real wages in the private and public sectors fell by 2.7 and 2.4 percent, respectively. The FSM experienced high rates of inflation during the GFC, eroding the small increases in nominal wages. During the subsequent period between FY14 and FY21, financial conditions improved significantly with large increases in sovereign rents. Over this period, inflation was low, averaging less than 1 percent per annum. Real wages grew by 1.6 and 1.1 percent in the private and public sectors, respectively.

More recently, in FY21-FY23, inflation eroded the value of real wages in the private sector, but with the large increase in public sector wages, real wages also grew. During the FY21-FY23 period, private sector wages grew by an annual average of 8.5 percent but after inflation fell by 2.7 percent. In the public sector, nominal wages grew by 16.0 percent, but real wages grew by 4.0 percent. Given the high rates of inflation, the reduction in real wages in the private sector is to be anticipated. However, in the public sector, civil servants were awarded a 45 percent pay rise in the four State and National governments. Much of this increase would occur in FY24 and is not fully reflected in the data through FY23.

The wage differential between private and public sectors has remained remarkably static since FY04. The wage differential between the private and public sectors has been large throughout C-03 although the different skill mix between the two sectors would explain much of the difference. While there has been a slight decline in the ratio it has changed little. Since COVID, labor market conditions have tightened in the private sector, reflecting significant out-migration, and leading to skill shortages and rising wages. However, this has

Figure 6: Nominal and real private and public sector wages, FY15 prices
Real Wages decline while public/private sector wage differential remains large



been offset by large increases in public sector wages during FY23 and FY24, so the net impact on the wage differential has little changed.

2. Fisheries Developments and Policy

The Parties to the Nauru Agreement and Vessel Day Scheme have proven to be highly beneficial to the FSM. Fishing in the region now effectively comes under the Parties to the Nauru Agreement (PNA), a cartel of 9 Pacific Island states including PNG, which has led to a remarkable and sustained increase in member country revenues from the Vessel Day Scheme (VDS) and sale of vessel days. The PNA has led to a fivefold revenue increase for the FSM since the start of the 2003 amended Compact. Daily fishing rates average close to $11,000 per vessel day from which the FSM received $72 million in revenues (16 percent of GDP) in FY23. Each PNA member is accorded a Party Allowable Effort (PAE) that is set in relation to the size of its fishery. The PAE for the FSM is understood to be close to 7,300 vessel days.

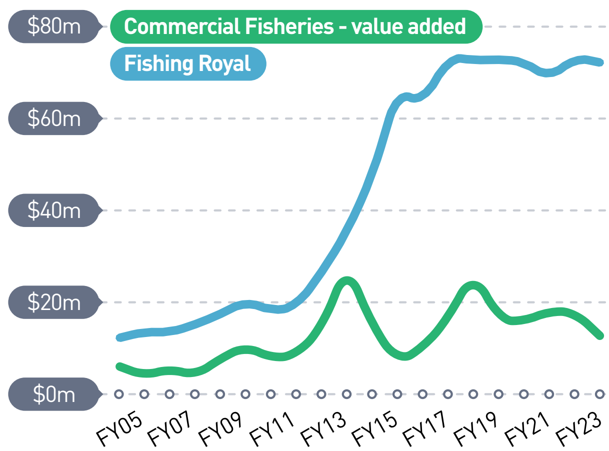
The FSM purse seine industry is comprised of 37 flagged vessels, 6 of which are residents and 31 non-residents. Resident vessels are represented by those companies that have a center of economic interest in the FSM and contribute in a significant way. There are two such companies Caroline Fisheries Company based in Pohnpei and Diving Seagull in Yap. CFC currently has 5 vessels, whereas Diving Seagull used to have 2 vessels but is now reduced to one after its largest and economically more important vessel sank in 2023. The non-resident component of the industry is comprised of a set of vessels that make minimal contribution to the economy and are classified in the FSM's economic statistics as non-resident. In FY24 there were 31 such vessels represented by 3 main companies: Taiyo (3), Kasar (4) and Liancheng (14). The remaining 10 vessels are largely individually registered but of Chinese origin.

While fishing royalties make a significant contribution to the economy, resident commercial fisheries operations are small in comparison and highly volatile. Figure 7 provides a picture of the value of the industry for the FSM. Fishing royalites are paid by all vessels operating in the FSM regardless of whether they are FSM flagged or not. These revenues rose dramatically between FY11 and FY17 and made a major contribution to the economy, 16 percent of GDP. Commercial fishing, represented by the two resident purse seining companies, shore-based transhipment entities, and other small fishing companies have grown during C-03 but make only a small contribution to the economy, falling from 4.2 percent in FY22 to 2.8 percent in FY23 after a reduction in number of boats. The local commercial fishing industry has been highly volatile, depending on the fish catch and the number of purse seiners operating (rather than being out of service due to dry docking) at any one time.

The FSM arrangement (FSMa) provides large discounts to promote the development of the local fishing industry. The locally flagged purse-seine fishing fleet comes under a regional arrangement among Pacific nations, known as the FSM arrangement (FSMa). Under the FSMa, the fishing companies negotiate a daily rate at a significant discount, which allows operators to fish in any of the jurisdictions that come under the FSMa. However, for fish caught by FSMa vessels in other FSMa jurisdictions a transfer fee of $4,000 is required. The negotiated price between the operators and their home jurisdiction must therefore account for the $4,000 discount. With an average $11,000 daily market VDS rate the maximum that FSMa signatories can charge would be $7,000 to accommodate the possible need for the transfer fee. This results in a significant loss in fees for fish caught in the home country.

Figure 7: Fishing royalties and commercial fisheries value added

Fishing revenues have grown dramatically but value added has been volatile and stagnated since FY12



The FSMa was established to encourage the long-run development of the tuna fishery. However, it is questionable as to whether non-resident domestically flagged vessels make a significantly greater contribution to the economy than third-country fishing vessels, which operate without a discount.

Estimates of the financial and economic loss due to the FSMa are likely to be substantial. The justification for registration under the FSMa is that domestically flagged vessels generate an economic benefit greater than the discount. Estimating the gross loss in VDS sales is problematic due to the paucity of information on VDS sales, discounts, and transfer fees. However, with 31 non-resident vessels fishing for 200 days a year with an average discount of $4,000 per day, the annual gross loss would be $24.8 million. Against this must be deducted the economic benefit of a

The FSM arrangement leads to distortions in the management of the Vessel Day Scheme and potential large loss of revenues.

vessel day. An unpublished study conducted by the GSUSA in 2019 suggested that the net benefit of an FSMa day compared with a bilateral non-FSM flagged vessel was about $700. This would imply a revenue loss for the national treasury of the full $24.8 million discount but a slightly reduced loss of $20.5 million for the economy.

There is a need for a transparent evaluation of the FSMa so the FSM public and policy makers can make informed and evidence-based decisions on the rationale for, and size of, the discounts. The above estimates are based on limited information to illustrate the magnitude of the potential loss to the FSM. Thus, careful evaluation of the benefits of domestic flagging of vessels under the FSMa is needed. This issue has been in question for some time due to the lack of transparency of the underlying economics of the arrangements. Only when there is full disclosure can FSM policy makers make informed and evidence-based decisions on whether the discounts provided are worth the cost. One alternative would be to replace the FSMa with the existing "pooled" system, where operators pay a market rate and are eligible to fish in any PNA jurisdiction. There has not been widespread uptake of the pooled system due to some jurisdictions believing they can increase their revenues through individual negotiations with the operators. A further and more efficient approachwould be to provide discounts or rebates to FSM-flagged vessels only upon presentation of proof of benefits derived from employment, taxes, and impact on the domestic economy through purchases of goods and services.

3. Fiscal Performance and Policy

Fiscal Performance Over the 2003 Amended Compact Period

State and National governments have operated within distinct fiscal envelopes. The FSM government consists of four State governments and a National Government, with the majority of responsibility for public service delivery—such as education, health, and public safety—lying with the State governments. The assessment of State and National Government performance is therefore presented separately. During the C-03 period, the State governments operated under similar fiscal conditions, allowing for a collective analysis. In contrast, the National Government, benefiting from substantial revenues generated by sovereign rents, has operated in a more favorable fiscal environment. This analysis covers FY04-FY24, utilizing audits through FY22, as well as financial data from the State and National governments' Financial Management Information System for FY23 and FY24. For FY24, complete data was available from all FSM states, while for the National Government, estimates are based on performance through July 2024.

State governments faced a constrained and declining fiscal position during the 2003 Amended Compact

State government performance

State governments experienced a declining yet balanced fiscal position during the C-03 period. With inflation-adjusted Compact sector grants declining and limited or no growth in domestic revenues at the state level, service delivery and public expenditures were severely constrained see **Figure 8**. The start of C-03 saw significant fiscal compression at the state level as governments adjusted to the new provisions. This led to large deficits, but by FY09, balance was restored following a reduction in force in Kosrae and Chuuk. Over the following years, fiscal balance was maintained, though both revenues and expenditures declined as a share of GDP. Toward the end of C-03, the constitutional amendment[4] splitting fishing revenues 50:50 between the states and the National Government resulted in a significant revenue boost in July 2023, reflected primarily in the FY24 figures. This change also contributed to the emergence of a fiscal surplus of 4 percent in FY24, as expenditures had not yet adjusted.

4 See below for discussion of the 2023 constitutional amendment splitting fishing revenues 50:50 between the State and National governments.

Figure 8: State government revenues and expenditures, percent FSM GDP

The fiscal position of the state governments was severely constrained during C-03 and declined as share of the economy

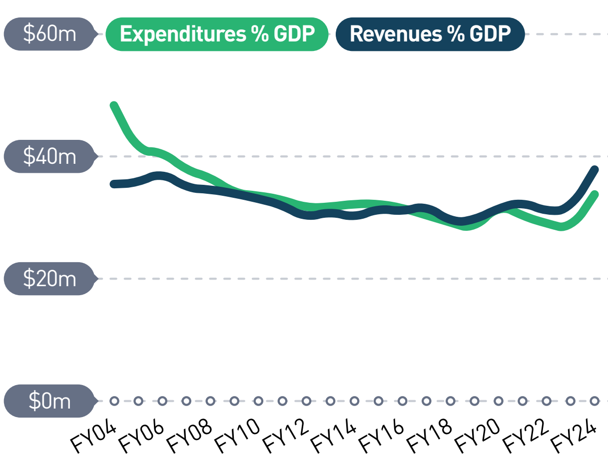
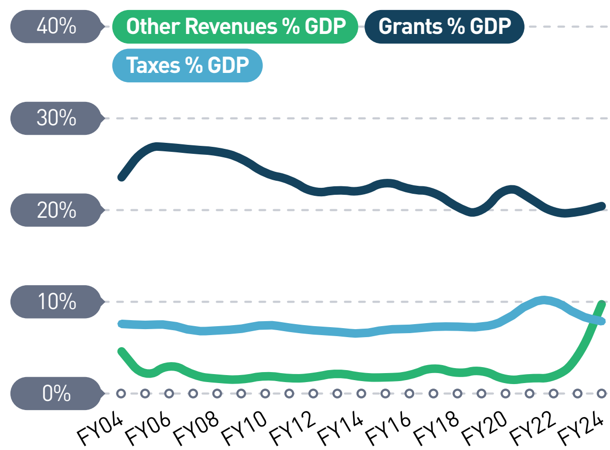


Figure 9: State government composition of revenues, percent FSM GDP

Compact grants declined as a share of GDP while other revenues remained largely stable

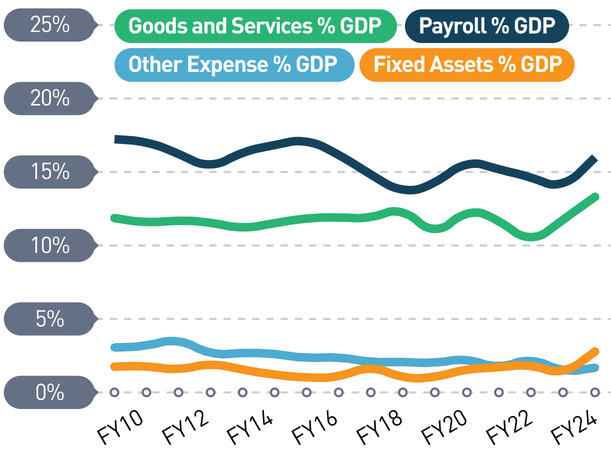


The decline in revenues at the state was largely due to the decreasing real value of Compact sector grants.. The annual Compact sector grants, the main component of grants at the state level, have been subject to inadequate indexation and an annual decrement. As shown in **Figure 9**, these grants declined in real terms during C-03 and also as a share of GDP. Under the new Compact (C-23), annual sector grants have increased significantly, from $100 million to $140 million, though FY24 data does not yet fully reflect this change. Tax revenues have remained largely constant in relation to GDP. Although they rose significantly in the COVID years, it is not entirely clear as to the reasons. Other revenues were modest and largely unchanged in relation to GDP, but saw a significant rise in FY23 and FY24 due to the increase in the States' share of fishing revenues.

Reflecting the constrained fiscal position, most expense categories have declined as a share of GDP. While payroll expense as a share of the economy has declined (see **Figure 10**[5]), they have gradually increased in nominal terms. Despite wage freezes and constraints

5 Disaggregated data enabling a break-out by GFS major category only became available in FY12.

Figure 10: State government composition of expenditures, percent FSM GDP
While payroll expense declines as a share of GDP, use of goods and services remains constant



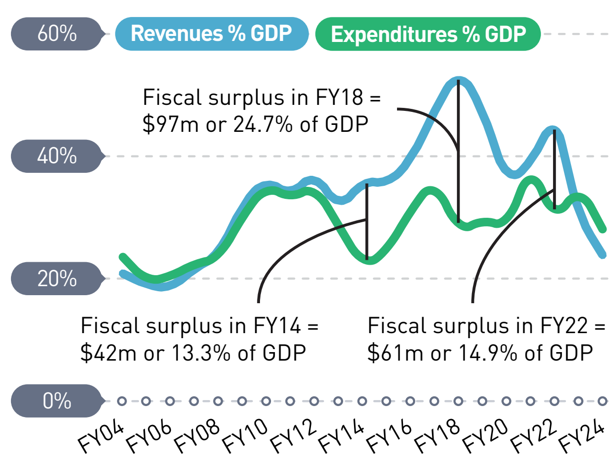
during most of C-03, the system's inherent annual wage drift resulted in a nominal wage bill increase of 1.6 percent per year. At the start of 2023 the National Government implemented a 45 percent pay increase for employees. This was subsequently implemented at the state level in FY24 and resulted in a large increase in payroll at the start of FY24[6]. Use of goods and services grew modestly in nominal terms and remained constant as a share of GDP. In FY24, the two smaller states of Kosrae and Yap posted a significant increase in use of goods and services, largely exhausting the fiscal space created by the new Compact and increased fishing revenues. In Chuuk and Pohnpei the use of goods and services were held at prior levels although increases are expected as they adjust to the levels of C-23. While the "other expense" category declined as percent of GDP, gross fixed capital formation, although small, held steady.

National government performance

Although the National Government ran large fiscal surpluses, recent sustained growth in expenditures and changes in revenue sharing led to deficits in FY23-FY24. At the start of C-03 through FY13 the National Government's fiscal position remained largely balanced (see Figure 11). Both revenues and expenditures grew rapidly, driven by major airport improvement projects and infrastructure spending funded by U.S. Compact infrastructure grants and FAA grants. In FY14, revenues began to expand significantly due to growth in sovereign rents, fishing fee royalties, and the FSM domicile for captive insurance and major Japanese corporations. Large periodic receipts from the domicile boosted revenues and resulted in surpluses. However, sustained growth in expenditures and a constitutional amendment in FY23 requiring the National Government to share fishing fees equally with the states led to the erosion of the surplus. By FY24, the National Government's fiscal position had come under pressure, as it struggled to maintain fiscal balance. From FY14 through FY22, the

The National Government ran a large fiscal surplus in the 2010s, reflecting booming sovereign rents.

Figure 11: National government revenues and expenditures, percent FSM GDP
Since FY13 the national government has run large fiscal surpluses



6 The volatility in the payroll-to-GDP ratio reflects volatility in the denominator, GDP.

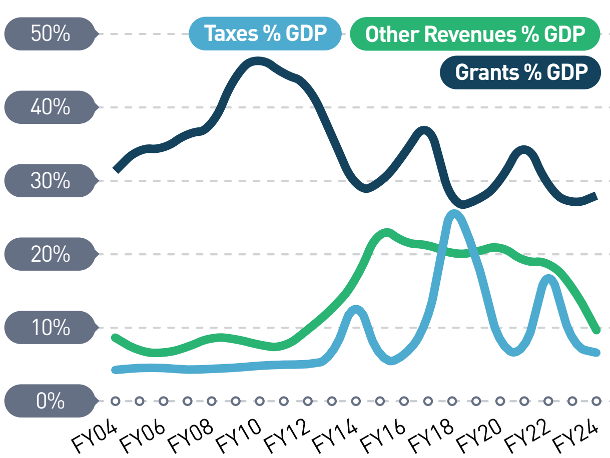
National Government maintained a fiscal surplus averaging 12 percent of GDP. However, preliminary figures for FY23 and FY24 suggest that this surplus has turned into a deficit, averaging 4 percent of GDP.

Grants grew rapidly during the early years of the Compact through FY10 but have declined steadily through FY24. While the National Government's share of the operational Compact sector grants has been small, all infrastructure grants and FAA airport improvement projects have been managed, for most of C-03, by the National Government. At the start of C-03 both taxes and other revenues were small; most of the National Government's revenues were derived from infrastructure grants and the FAA projects, see Figure 12. These sources grew rapidly through FY10, peaking during that period, but since then, they have gradually declined in significance. The end of FAA projects, combined with persistent underutilization of C-03 infrastructure funds, led to lower levels of receipt and use of U.S. grants. However, the FSM's designation as "grant only"[7] resulted in a large increase in multilateral grants from the World Bank and ADB. Further, in FY20 and FY21 the FSM was in received large COVID mitigation and related funds, primarily from the US and ADB.

7 See discussion under section on external debt.

Figure 12: National government composition of revenues, percent FSM GDP

Grants decline as a share of GDP while sovereign rents increase rapidly but fell in FY23

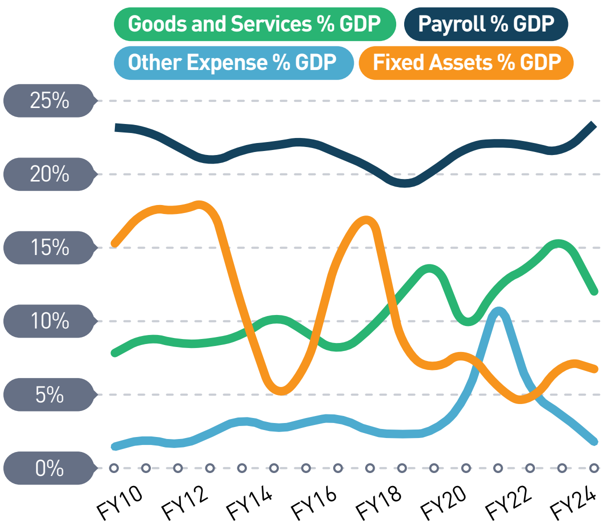


Fishing fee revenues and receipts from the FSM domicile for Japanese captive insurance and major corporations have grown rapidly in recent years. In addition to grants, the National Government benefits from the receipt of sovereign rents from fishing royalties under the Parties to the Nauru Agreement and implemented through the Vessel Day Scheme. Fishing royalties have grown steadily from 5 percent of GDP at the start of C-03, to an average of 17 percent of GDP from FY22 through FY24. In FY24, receipts from fishing licenses were $72 million. The National Government has also established an FSM tax domicile, primarily for Japanese captive insurance and major corporations. While this has typically represented around 3 percent of GDP, its contribution to national revenue spikes periodically. For example, in FY18 and FY19, it averaged 19 percent of GDP due to large tax declarations (capital gains) by major corporations, and again in FY22, it peaked at 14 percent of GDP. Figure 12 illustrates recent trends in both taxes and "other revenues." The tax category includes both domestic taxes, which have remained largely constant as a share of GDP, and offshore corporate taxes, which have been highly volatile. "Other revenues" includes a small portion from miscellaneous government sources and a much larger component from fishing fees. In FY23 and FY24, National Government "other revenues" declined sharply, a reflection of the constitutional amendment on revenue sharing.

While payroll expenses have remained largely stable as a share of GDP, expenditures on goods and services have risen rapidly, and outlays on fixed assets have decreased. Payroll expenses have followed a pattern similar to the states, but have grown in nominal terms at a slightly faster rate of 2.7 percent per year, 1.1 percent higher than the states (see Figure 13[8]). Use of goods and

8 As in the case of the state governments, payroll growth has been constant, the volatility in the figure reflects change in nominal GDP.

Figure 13: National government composition of expenditures, percent FSM GDP
While payroll costs remain a constant share of GDP investment in fixed assets declines



services has been the major area of growth in National Government expenditures, growing by 7 percent per annum in nominal terms. "Other expense" has been relatively stable with the large growth in FY20-FY21 reflecting the COVID period. Both the use of goods and services and "other expense" fell in FY24, reflecting the tightening fiscal position. The largest area of decline has been in fixed asset expenditures, which fell significantly following reductions in FAA and Compact infrastructure grants between FY09 and FY13, as well as in multilateral grant projects during the COVID period.

THE FSM Trust Fund and National Government's Structural Surplus

The FSM Trust Fund (FSMTF), established at the start of C-03, became an effective tool for saving surplus funds as fiscal conditions improved at the FSM National Government. At the start of C-03 the FSM National Government established a national trust fund (FSMTF) to save resources for future funding needs following the expiration of the Compact.

The majority of the fiscal surplus contributed to the strong growth in the FSM Trust Fund which attained a value of over $500 million by the end of FY24.

Initially, contributions were small, but by FY14 the FSM had accumulated to $22.5 million. In FY14, the FSM National Government began experiencing rapid growth in sovereign rents, including fishing royalties and corporate tax receipts from the domicile for major Japanese corporations. With this increase in fiscal surplus, the FSMTF provided an ideal vehicle for depositing and saving additional resources. The National Government legislated the allocation of 20 percent of its share of domestic taxes (50 percent by constitution) to the establishment of State sub-accounts of the FSM Trust Fund[9]. It further decided to transfer 20 percent of fishing fees to the FSMTF and 50 percent of the revenues from corporate taxes[10]. As a result of these actions and with accumulated earnings, the FSMTF had reached $525 million by FY24, of which $66 million was held on behalf of the State governments—a remarkable achievement.

Large fiscal surplus also supported rapid growth in FSM Congressional projects. However, savings of additional resources into FSMTF was not the only use of the surplus funds. In fact, only 42 percent of the additional funds were transferred to FSMTF (see **Figure 14**[11]). In addition to accumulating the funds in FSMTC, the National Government allocated a significant portion of the surplus—27 percent—to Congressional electoral district projects. In this *Review*, the structural surplus is used as a measure of the fiscal position, which includes discretionary resources not part of regular government operations, such as FSM Congressional projects. As the figure indicates,

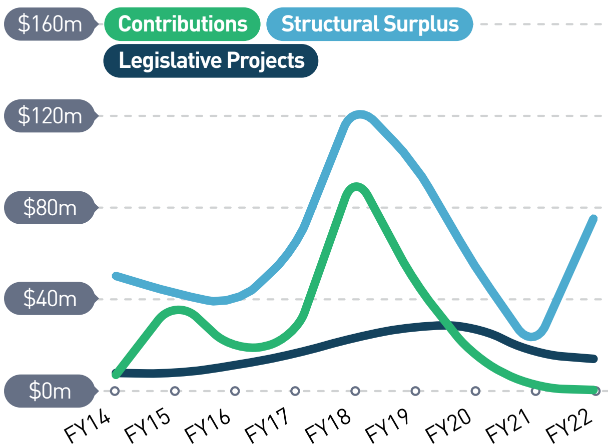
9 See FSM Congress Public Law 18-107, 2015.

10 See FSM Congress Public Law 20-130, 2018.

11 Based on FSM National Government audits.

Figure 14: Allocation of national government structural surplus

FSM structural surplus has been allocated to contributions to the FSM Trust Fund and legislative projects



these expenditures grew strongly, maxing out at $29 million in FY20. The remaining component of surplus funds, 31 percent, is represented in cash reserves or other financial assets held by the National Government.

As a result of a constitutional amendment requiring that fishing fees be shared with the States, the National Government ceased its allocation of revenues to State sub-accounts of the FSM Trust Fund (FSMTF) and reduced other contributions to the FSMTF. While it might be argued that the increase in the FSM's resources had represented a lost opportunity in service delivery at the state level, the National Government had purposely avoided a destabilizing rise in state-level recurrent expenditures, which, given the uncertainty surrounding Compact renewal, would likely have been unsustainable. However, the growing disparity in resources between the States and the National Government led to the proposed constitutional amendment to share fishing fee royalties equally between the National and State governments. This amendment was passed through a plebiscite and became part of the Constitution in July 2023. In response, the National Government repealed the 20 percent allocation of National Government revenue to the FSMTF's state sub-accounts[12], along with the 20 percent share of fishing fees and the 50 percent allocation of corporate taxes from the FSM domicile that had previously been directed to the FSMTF[13].

The constitutional amendment requiring a 50:50 share of the nation's fishing fees reversed the fiscal position between the state and national governments.

The changes in revenue allocations and rising expenditures left the National Government with a deficit in FY23 and FY24. The net impact of these changes on the National Government's budget in FY23 included a loss of 50 percent of fishing fee royalties, offset by a return of $7 million from the revenue share, $14 million from fishing fees, and an average of $5 million from corporate taxes, totaling $26 million. As a result, the National Government experienced a net loss of $9 million in resources. However, the impact on the fiscal position is more complex. Prior to the changes, the National Government was effectively required by its own law to run a fiscal surplus of $26 million in order to allocate the same amount to the FSM Trust Fund (FSMTF), a "below the line" transaction. After the changes, the National Government lost $36 million in fishing royalty revenues but regained $26 million to fund its operations—essentially restoring the previous fiscal surplus. This resulted in a smaller fiscal adjustment of $9 million. Given the rising trend in expenditures during C-03, the emergence of a fiscal deficit in FY23 and FY24 is anticipated.

12 See FSM Congress Public Law 23-31 September 2023.

13 See FSM Congress Public Law 23-23, September 2023.

Tax Reform

FSM tax reform has been low on the agenda but warrants reconsideration as the nation enters the new Compact era. In the mid-2000s the FSM embarked on a lengthy process of tax reforms, which, after many years of donor support and hard work by officials of all five governments, had not resulted in any significant reform. Two of the four FSM states (Chuuk and Kosrae) supported the tax reform initiative. Yap State, while expressing no objection to the reforms, indicated that the proposal was unconstitutional with respect to Yap's state constitution and thus failed to participate. Pohnpei state generally had a business community opposed to tax reform. More recently, renewed efforts have periodically appeared. The weak fiscal position in Pohnpei re-ignited interest and the former National Government administration created a tax reform task force. Under the current administration, an executive order has been issued to review existing taxes and make recommendations on tax reform. It is understood a committee has been created to drive the process.

With the change in revenue-sharing between the governments of the FSM, greater incentive now exists to adopt a tax reform agenda. While the National Government had little incentive for additional revenue effort during C-03 due to booming sovereign rents, this situation has now changed with the loss of 50 percent of fishing royalties and the National Government running into deficit in FY23-FY24. While State governments are now in a stronger fiscal position, both Kosrae and Yap have already absorbed the additional funds. With the recent payroll increases, similar trends are likely are likely to be observed in Chuuk and Pohnpei. If the FSM thus wishes to strengthen its fiscal position and ability to support development into the new Compact era, reconsideration of the tax reform and a modernization effort should be high on the reform agenda. With the recent success of tax reform in Palau and consideration of a similar package in the Marshall Islands, experience in the region should provide confidence for the FSM to follow the same path.

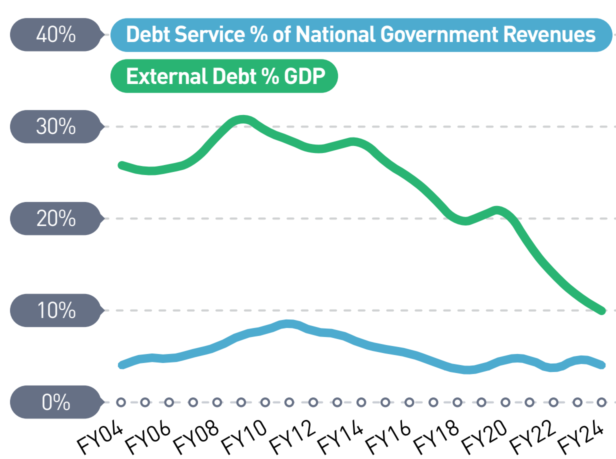
External Debt

FSM has an admirably low external debt profile. FSM's external debt, at 10 percent of GDP, is one of the lowest in the region. Debt service of 4 percent of National Government domestic revenues remains well within the capacity of the National Government to service and does not present any threat of debt stress, see Figure 15. A review by the FSM public auditor in July 2014 revealed many weaknesses in FSM's external debt management. As a result, a debt management bill was drafted in 2017 but no action was taken by the FSM Congress.

Addressing debt management as part of improving Public Financial Management (PFM) sooner—while debt distress is not a concern—rather than later is advisable.

FSM loses "grant-only" status to be replaced with a blend 50:50 of grants and loans. In 2013 the IMF/World Bank conducted a Debt Sustainability Analysis of the FSM economy resulting in the nation being declared at risk of high stress. While debt was low at that

Figure 15: External debt ratios
External debt has fallen as a percent of GDP; debt service remains sustainable



FSM maintains a low external debt profile without serious risk of debt stress.

time the potential large fiscal impact of a failure to renew the Compact with the US in 2024 was considered to potentially lead to significant fiscal stress and large unstainable incurrence of external debt. As a result, the FSM was placed on "grant only status" by international donors[14]. However, after the successful renewal of the Compact in 2024, these conditions no longer prevail, and the FSM is no longer considered at risk of high debt stress. Thus it lost its grant-only status, that was replaced with a "blended" 50:50 mix of grants and loans[15]. To place this in perspective, the FSM has been eligible for an average of $30 million in grants from the World Bank and $20 from the ADB. Clearly, this result is not favorable to the FSM. Given its historical reluctance to incur debt, the FSM will need to formulate a debt management policy on what terms and conditions it may be willing to incur debt.

14 In reality, the FSM does not have access to international capital markets to finance debt as assumed in the DSA analysis. However, clearly the designation of "grant-only status" has been hugely beneficial to the FSM.

15 IMF, Federated States of Micronesia: 2023 Article IV Consultation, Washington DC, March 2023.

4. The Financial Sector

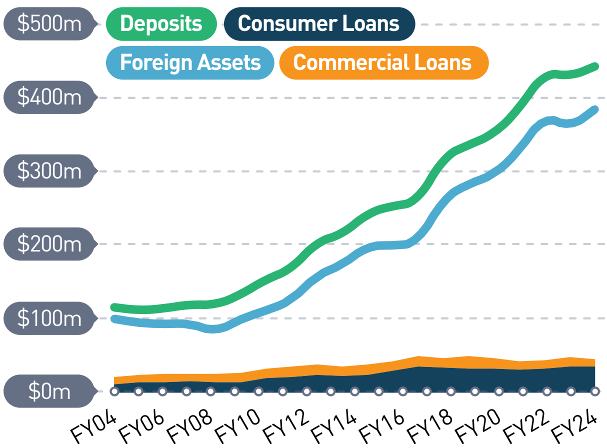
Banking

The FSM banking sector is limited to two commercial banks and a development bank. The banking system in the FSM is regulated by the FSM Banking Board, whose role involves banking supervision: monitoring and analysis (off-site), examination activities (on-site), and corporate activities (laws and regulations, licensing, and enforcement). The FSM Development Bank does not currently fall under the regulatory inspection of the Banking Board. There is one US bank, the Bank of Guam, operating as a branch of its parent registered in the United States, which comes under US federal supervisory requirements and is insured by the FDIC. There is one locally owned bank, the Bank of the FSM, also insured by the FDIC. Although the financial system has provided satisfactory and secure banking services, the marketplace, because of its small size and lack of a well-developed supervisory capability, requires careful monitoring.

The deposit base grows strongly in the 2003 amended Compact period. Deposits in the FSM grew strongly during C-03, averaging 8 percent per annum and attaining a level of $443 million in FY23, which exceeded the level of GDP, see Figure 16. Private sector deposits grew consistently during the period and even during COVID and subsequent recovery maintained their upward momentum. The FSM did not follow the same buildup of deposits during COVID and subsequent runoff during the recovery phase as experienced in other countries. However, National Government

Figure 16: Commercial bank deposits, loans, and foreign assets, end of period

Commercial bank lending remains weak with funds invested offshore



deposits, after strong growth during the period of rapidly growing sovereign rents, peaked in FY21 and fell off in FY22-FY23 as the fiscal position deteriorated. In addition, both state governments, municipalities and SOEs have shown strong growth in deposits rising from $14 million in FY04 to $104 million in FY23.

Lending to the private sector in the FSM has been weak while commercial credit represents a mere 2.7 percent of deposit liabilities. While deposit growth has been robust, lending performance has been weak. Total lending to the private sector, including both consumer and commercial loans, has grown from a level of $21.3 million at the start of C-03 to $45.6 million in FY23. While consumer lending has shown growth and is the mainstay of commercial bank lending, commercial credit has remained unchanged during C-03. In FY23, the loans-to-deposit ratio stood at 10.3 percent, with 7.9 percent represented by consumer loans of, $34.9 million, and 2.4 percent by commercial loans of $10.7 million.

Many structural impediments constrain private sector lending in the FSM. The low rate of domestic lending reflects the perceived high risk of lending in the FSM and "lack of bankable projects." Overall, the inability of businesses to prepare credible business plans and financial statements, the lack of collateral, and the limited ability to use land as security have inhibited development of the financial sector. The lack of a modern tax system that would require prepared financial statements, as well as the inadequate provisions for securing transactions have further impeded financial sector deepening. With limited local opportunities, commercial banks have preferred to invest their assets offshore in less risky and more secure markets.

Rapid growth in commercial bank foreign assets reflects weak private sector credit growth. On the flip side to the low and weak growth in commercial bank lending, foreign investments have risen strongly by 9 percent per annum since FY04 from a level of $100 million, attaining a value of $385 million in FY23. The large accumulation of foreign assets represents the lack of domestic lending opportunities reported by the commercial banks.

Social Security Sustainability

Recent actuarial assessment of SS indicates a funded ratio of 13 percent. As of January 2023, an actuarial assessment of the FSM Social Security Fund[16] indicated an accrued liability of $371 million as compared to assets of $50 million, a funded ratio of 13 percent[17]. Contributions to the fund in FY23 were $23.2 million, with $25.7 million in benefit payments, that is, contributions covered only 90 percent of benefit payments and Social Security required additional funding to make up the shortfall. Investment returns were large in FY23 at $7.5 million, reflecting strong market performance as compared with normal market returns

16 CavMac Actuarial Consulting Services, *Actuarial Assessment*, Omaha, Nebraska, January 1, 2023.

17 The unfunded liability indicates the resources required to liquidate current and future liabilities at a given point in time. It is not a good indictor of the long-run sustainability of a defined benefit scheme such as the FSM Social Security system.

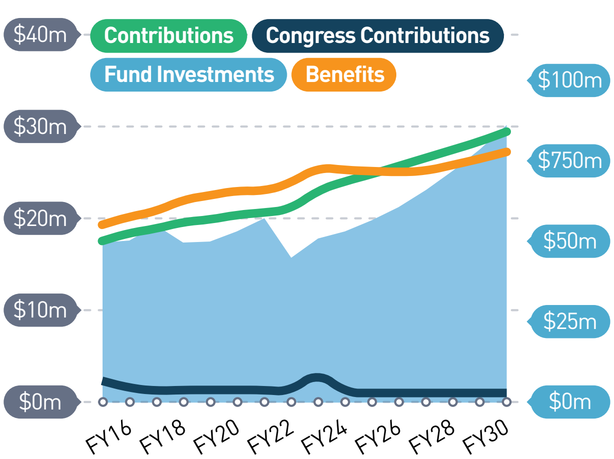
> *Projections indicate the sustainability of Social Security should remain favorable but requires careful monitoring*

of 5.72 percent experienced over a 28-year time period. In recent years the National Government has provided a $1 million annual appropriation to support the SS fund, although in FY23 it rose to $2.5 million. Reflecting these finances, fund investments rose from $45 million in FY22 to $50 million in FY23.

Over the projection period considered in this Review, sustainability of the Social Security FUnd looks favorable. Projections of the Social Security Fund over the time horizon considered in this Review indicate contributions will exceed benefits in FY25 and investments will grow, see Figure 17, Benefits are projected to remain largely unchanged through FY27 and then to grow at an average rate of close to 3 percent according to the Social Security actuarial evaluation conducted in January 2023. The GSUSA's economic model (MTEF-mod) projects SS contributions in tandem with wages which are to projected to grow at an annual rate of 4.1 percent through FY30. Investment returns are projected at 5 percent. The resulting outcome indicates fund investments will increase by $39 million and that the underlying financial position and sustainability of the Social Security system will improve. Two caveats to these projections are detailed below.

Figure 17: Social Security funds, benefits and contributions

FSM Social Security funds have been sustainable, and over the current horizon contributions are projected to exceed benefits



Long-run projections of the health of the Social Security system are subject to a wide margin of variance and require careful and regular monitoring. Firstly, the actuarial evaluation was prepared before the recent hike in National and State government payroll of 45 percent. This strongly affects the future contribution stream. In the actuarial evaluation, an annual growth of 2.75 percent for payroll was assumed, well below the average 4.1 assumed here. While the benefit streams of the projections are similar, the actuarial assessment assumed an investment return of 7 percent. Secondly, the payroll projections during the remaining years of the current decade are based on a projection of the economy that assumes both an increase in infrastructure and growth in public services (see section 10 below). In comparison to the favorable projections presented here, the actuarial assessment presents a picture of long-run decline and eventual collapse of the Social Security system. The sensitivity of the projections to small changes in assumptions makes a large difference over the long run, suggesting that a regular checkup of the system is warranted.

FSM Domicile for Japanese Companies

The FSM has benefited mightily from the creation of the FSM domicile for major Japanese corporations. In 2005 the FSM passed corporate tax legislation that enabled the creation of an overseas domicile, which has primarily been targeted at Japanese companies. The law provides for a corporate tax rate of 21 percent, and through differential tax rates, the FSM host environment provides an attractive domicile for Japanese captive insurance companies and other corporations. The benefit of these arrangements has been a steadily growing stream of revenues to the National Government, averaging $6 million in recent years from captive insurance companies, and occasional capital gains-related tax revenues from overseas investment companies. In FY14 there was an unusually large receipt of $28 million, reflecting a large declaration of capital gains by one company. In FY17 there was a further large receipt of $23 million by that same parent corporation. In FY18 there was a receipt of $77 million from a different Japanese organization and in early FY19 there was a receipt of $50 million. Although large payments can be expected periodically, FY18 and FY19 were exceptional.

A particular area of concern has been compliance with the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Global forum is a group of 146 members that are working under guidance of the OECD to create a transparent environment among nations to share information in the tax area; the FSM is not currently a member. As a result of phase 1's first round of peer reviews in 2015 the FSM was deemed non-compliant. In June 2016, there was a front-page article in the Nikkei Shimbum reported that Panama, Micronesia and Indonesia would be blacklisted by the Global Forum. The implications of being placed in the same group as Panama would have been damaging to the FSM's reputation, and any inclusion on this list could have catastrophically impacted the FSM domicile and captive insurance industry.

> *The FSM domicile for major Japanese corporations has made a significant contribution to the FSM economy although threats exist.*

The FSM's efforts to respond to a severe threat resulted in the FSM now being deemed largely compliant with Global Forum and OECD requirements. As a result of Global Forum non-compliance, the FSM enhanced its efforts and passed legislation on transparency and exchange of tax information. In 2016, the Global Forum undertook a fast-track process and countries were designated either compliant, largely compliant, partially compliant, or non-compliant. Following the review, the FSM was designated as largely compliant, thus alleviating the fears arising from the Nikkei Shimbum article. A further, second-round peer review rated the FSM as largely compliant. Earlier concerns have thus been largely addressed, and the FSM has even stated that it intends to join the Global Forum as a member to maintain its good standing into the future.

Risks exist should Japanese lawmakers enact stronger provisions toward offshore tax domiciles. Additional risks to the industry have resulted from changes in Japanese corporate law concerning tax haven status. In addition to requiring foreign jurisdictions to have an income tax burden in excess of 20 percent, foreign domiciled companies are required to display substantial business activity rather than paper or cash box type functions. The exact nature of "displaying substantial business activity" is not yet known, but it will require a physical office and an administrator for each Japanese subsidiary in the FSM.

FSM domicile revenues are not subject to revenue sharing but an unknown level of risk exists if competition should emerge between FSM states. At present, the industry resides in Pohnpei although corporate taxes generated from the FSM domicile are not treated as subject to FSM revenue sharing, and thus only generate direct revenue to the National Government. However, should the current arrangements be contested by the state governments, and the issue taken to court, it could lead to a loss of confidence among Japanese companies and a loss of revenue for the FSM. Business performs well in an environment of stability and predictability; forces that jeopardize or undermine the current status quo should be strongly discouraged.

5. Public Financial Management (PFM)

Public Expenditure and Financial Accountability (PEFA)

FSM has undertaken PEFA assessments in 2012 and 2016 and prepared a PFM Road Map in 2017. In September 2011 the FSM National Government, with support from PFTAC, conducted a PEFA self-assessment[18], a scored system of PFM established by the World Bank. Little action was undertaken on PFM reform until 2016 when a further PEFA self-assessment was conducted, again supported by PFTAC. The assessment concluded that "*overall the FSM PFM system shows a considerable improvement over the 2012 assessment, and that PFM systems overall are operating at average or above average levels when compared to other pacific nations*". Later in 2017, the FSM prepared a PFM Road Map,[19] indicating "*Key areas to be addressed over the next three years to improve current systems, to better align resources and accountability towards development results, and to present a sound basis for development partners to provide general budget support include*:

1. Implementing a new financial management information system including integrating a budget

18 FSM PEFA team, FSM Public Financial Management Performance Report and Performance Indicators, January 2012.

19 FSM Department of Finance & Administration, Public Financial Management Roadmap 2017 – 2020, FSM Department of Finance & Administration, Palikir Pohnpei, July 2017.

FSM should consider rolling out PEFA's and PFM Roadmaps at the state level.

module and automating customs and tax systems;

2. A complete review of the Financial Management Regulations;
3. Improving reporting standards (including developing a new website); and
4. Continued efforts on staff capacity development.

With EU support a TA was conducted to advance PFM reform and enable qualification for budgetary support programs. In order to support PFM reform and improvements, the EU provided technical assistance to the FSM in 2022 and 2023 to coordinate and drive the process. In part, the effort was also motivated to enable the FSM to fulfill conditions required for budgetary support by the EU and other partners such as the World Bank. A further PFM roadmap[20] was prepared, covering the period 2023-2026, but unlike the more formal roadmap that addressed specific PEFA objectives in 2017, the EU-supported 2023 version focused on a list of credible and relevant PFM actions:

1. New Financial Management Information System. (See discussion in next section.)
2. New Revenue Management System. (See discussion in next section.)
3. New ASYCUDA World Customs System, which is now operational.
4. Updated standard operational budgetary procedures. A budgetary manual with standard operating procedures was prepared and training conducted as part of the EU TA.
5. Updated Financial Management Regulations. The National Government is currently operating the new FMR, which has yet to be harmonized at the state levels.
6. Improving public debt management.
7. Improving management of the FSM Trust Fund.
8. Simplifying drawdown procedures for Federal Grants.
9. New municipal government payments system.
10. New Tax Initiatives. (see section 3).

FSM National Government issues a citizen's budget. In addition to the above actions, the EU TA supported the preparation of a citizen's budget for FY24. With the lack of publicly available information on the National Government's budget, this document was an important addition.

PEFA and PFM Roadmaps need to be rolled out at the state level. While the actions of the TA included state-level participation, preparation of PEFAs or the subsequent roadmaps have only been conducted at the FSM national level. To be of value throughout the FSM, the PEFA exercise and PFM roadmaps need to be rolled out at each of the four FSM states, where most of the public expenditures take place. While it is understood this was part of the EU TA objectives, resources were insufficient to provide any significant state rollout.

Financial Management Information Systems (FMIS)

The implementation of a new Financial Management Information System (FMIS) in the FSM, supported by the World Bank, has

20 Public Financial Management Roadmap, 2023-2026, Palikir Pohnpei, 2023.

experienced delays. The FSM's current FMIS is nearing the end of its effective life, as the software company has ceased support for its declining user base. With donor support from the World Bank, a replacement system has been pursued. A project manager was hired, and consultants were selected to guide the FSM through a needs assessment, development of a Request for Proposals (RFP), and selection of suitable software. After a prolonged period and a series of management challenges, including the replacement of key implementation staff, the RFP was issued, and a system was selected. However, the original vendor, Bisan, backed out after realizing the project required operationalizing the system across all five FSM governments. The next highest-ranked vendor, FreeBalance, a Canadian system with a significant user base, was then chosen to implement the project. Implementation is now underway, with a target "go live" date of October 1, 2025, at the National Government. The system will then be rolled out to the other FSM State governments sequentially.

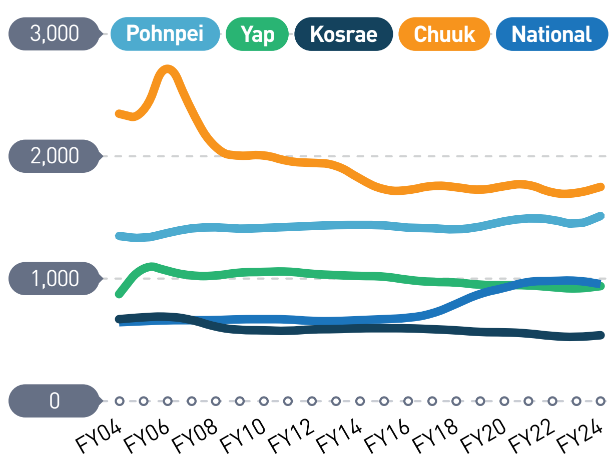
The new Revenue Management System (RMS) is expected to significantly enhance compliance and revenue collection. In addition to the new FMIS, the FSM requested support from the World Bank to implement a new RMS that will interface with the FMIS. A project manager has been hired, an IT expert recruited, an RFP issued, and a vendor selected. The development of the RMS, which is being built in Armenia, is currently underway and is nearing testing and acceptance. This new RMS could greatly assist in the compilation of GDP by industry statistics, as discussed earlier.

Public Sector Payroll

The size of the civil service declined in Chuuk, Kosrae and Yap but grew in Pohnpei and the National Government. Given the dominant structure of government in the FSM, representing 63 percent of GDP in FY23, it is important to monitor public sector payroll given not only its importance to economic performance but also its impact on the fiscal position. Figure 18 provides a picture of employment in each of the five governments and changes through C-03. At the start of C-03 both Chuuk and Kosrae states underwent a severe adjustment to the then-new Compact and executed a Reduction in Force. In those two states and Yap, which experienced a constrained fiscal envelope, the size of the civil service fell during C-03 by 1.9 percent, 1.1 percent and 0.5 percent per annum, respectively. In the case of Pohnpei and the National Government, there was room for expansion in the civil service, as economic performance was positive, and the National Government had large fiscal surpluses., The civil service expanded by 0.4 percent per annum in Pohnpei state and 2.3 percent at the National Government.

Wage bills were contained during C-03 but started to accelerate as the period ended. While the size of the civil service had fallen in three of the FSM states, payroll costs grew reflecting changes in wage policy, see Figure 19. For Chuuk and Kosrae, wage costs were restrained, growing by an average

Figure 18: Employment in the civil service in the five governments of the FSM
Civil service declines in Chuuk and Kosrae and Yap but grows in Pohnpei and National

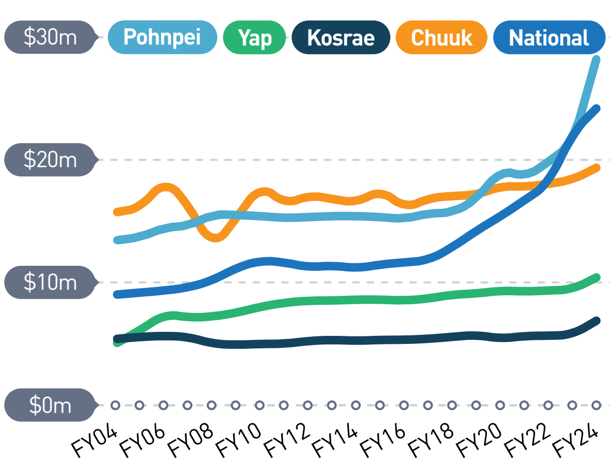


The FSM Strategic Development Plan needs improvement before it can provide a blueprint for the nation's development.

of 0.7 percent and 0.6 percent per annum, respectively during C-03. The large reductions in size were compensated for by some growth in wage rates, averaging 2.6 and 1.9 percent per annum, respectively. For Yap, the wage bill grew by 2.3 percent per annum, largely reflecting an annual wage increase of 2.8 percent. In Pohnpei, wage costs increases were moderate until FY19 when wage rates started to accelerate. At the National Government the combination of increased numbers of civil servants and wage rates gave rise to strong growth in the wage bill from FY17. During C-03 in the FSM as a whole the size of the civil service either fell or was tightly contained, but strong underlying pressure existed for upward adjustment in wage rates and cost of living increases.

National Government awards a 45 percent pay increase to its civil servants at the start of FY23 and the states follow suit in FY24.

Figure 19: Wage bill in the five governments of the FSM
Wage bill has grown significantly in National and Pohnpei state governments



During the period from FY04 through FY22, accumulated inflation in FSM recorded an increase of 70 percent. While National Government wage rates had risen by 33 percent, real wages adjusting for inflation had fallen by 22 percent. During this period, pressure for an increase in civil servant wages was mounting and the National Government awarded a 45 percent increase at the start of FY23. However, in the FY23-FY24 period the FSM experienced a rapid increase in inflation and the large pay-rise was inadequate to fully compensate civil servants for the cost-of-living increase since FY04. By FY24, real wages had fallen by 5 percent over the period. During FY24 all four state governments followed suit and adopted a similar 45 percent pay award. Since the state governments had not fully adjusted wages by the end of FY24 it is not yet possible to undertake a similar analysis at the state level.

The need for a civil service wage policy. The circumstances in the FSM during C-03 were not favorable to the adoption of civil servant wage policy. At the start of the period there was severe contraction in some states due to C-03 provisions. The annual decrement and lack of full indexation in Compact grants constrained consideration of any wage increase. The favorable fiscal position of the National Government enabled the provision of the large 45 percent increase in wages in FY23. In the states, the change in revenue sharing of fishing royalties favoring the states and better provisions of C-23 provided the resources for the states to follow suit in FY24. For C-23 the provisions for an orderly process of wage adjustment are more favorable. The FSM negotiated an additional $500 million contribution to the Compact Trust Fund in exchange to foregoing the 2 percent annual adjustor adopted in the Marshall Islands and Palau. These additional funds would enable annual drawdowns to compensate for annual cost-of-living changes. However, whether adoption of a civil service wage policy incorporating an annual automatic adjustment was appropriate needs careful consideration.

The FSM Strategic Development Plan: 2024-2043

The introduction of the Strategic Development Plan 2024-2042[21] defines the Goals of the Plan to be:

> *The FSM Strategic Development Plan (SDP) 2024-2043 serves as a guide for planning and budgeting for the Federated States of Micronesia for the next 20 years…*
>
> *The SDP 2024-2043 is designed as a high-level framework and includes broad strategic outcomes. Each of the States can align their priorities to the strategic outcomes through their state SDPs. The SDP enables the FSM at both the national and state level to prioritize planning and budgeting in targeted sectors and industries, develop infrastructure, and attract investments…*
>
> *The SDP 2024-2043 serves as the guiding framework to coordinate and align the National and State development goals, outcomes and outputs. It should be viewed by stakeholders as the FSM Roadmap for development and progress.*

The design and development of the SDP 2024-2043 was undertaken in three phases:

1. Review of SDP 2004-2023
2. Updated SDP 2024-2043
3. Monitoring and Evaluation Framework for SDP

However, while the SDP contains the first and second phase, the Plan states that the third phase has yet to be developed:

> *A monitoring and evaluation (M&E) framework will be designed and used to monitor the implementation and progress of the SDP. The M&E framework will include a results framework outlining specific goals, outcomes, and outputs across the nine thematic areas of the SDP 2024-2043. This framework contains indicators at each results level. The SDP will be implemented at the state level, with each state developing their own SDP aligning with strategic outcomes.*

The SDP defines a planning hierarchy with nine thematic areas:

1. Cultural Heritage
2. Education and Human Capital
3. Health and Well-being
4. Gender Equality and Social Inclusion
5. Governance and Institutional Strengthening
6. Peace and Security
7. Sustainable Economic Development
8. Environment and Sustainability and Climate Change
9. Infrastructure Development and Sustainability

Each thematic area defines a set of strategic outcomes (49) which are further elaborated through a discussion of a set of development priorities (184).

The SDP lacks a macroeconomic framework and an estimation of the costs required to implement the plan. The standard planning exercise is usually undertaken at two levels, providing (i) a macroeconomic and financing framework and (ii) sector-level objectives, plans and programs. The planning process involves optimization of the plan objectives subject to the set of resources available to the government. Macroeconomically, financing availability is compared with the cost of achieving the objectives and adjustments made to fit the fiscal envelope. The FSM SDP contains no macroeconomic framework, except in a very broad outline, and does not provide an estimation of the financial requirements to achieve the outcomes. Importantly, the SDP does not present and explore different

21 National Government, *FSM Strategic Development Plan 2023-2043*, Palikir, Pohnpei January 9, 2025; document transmitted by the President to the FSM Congress.

development scenarios and their potential impact on the economy and achievement of macroeconomic goals. For example, a comparison between the de facto public sector development scenario and a private-sector growth-oriented strategy could be assessed, along with the outcomes, merits, and impacts on economic and social development, employment, and fiscal self-reliance.

At the sector level, the SDP outlines strategic outcomes and development priorities but provides little detail on how these outcomes will be achieved. While at the sector or thematic level the SDP defines a set of strategic outcomes and a discussion of development priorities, it lacks specific projects or activities designed to achieve these outcomes. Furthermore, there is no itemization of sector activities and outputs that government departments would need to deliver. It appears that these details will be developed later through individual state SDPs, and that monitoring and evaluation matrices will also be designed at that stage.

The FSM Strategic Development Plan 2004-2023 provided a sound basis for development planning, budgeting, and Compact grant awards. While there is no established format in the design of a strategic development plan, the earlier FSM SDP 2004-2023[22] provides a good example of sector planning that met the needs of the 2003 amended Compact (C-03). Discussion of each sector was divided into three parts: (i) sector review, (ii) strategic goals, policy, and outcomes (measures), and (iii) activities and outputs. For each sector, a set of goals or objectives were defined. For each strategic goal, a set of outcomes or performance measures were listed to monitor progress These measures were closely aligned with Compact performance requirements. At the operational level, activities and outputs were outlined for each government department, with outputs designed to be measurable and monitored[23].

The SDP should be extended to incorporate the standard features of a strategic plan. The 2nd FSM SDP, as developed to date, provides an important but incomplete planning framework. The SDP needs to be extended to include the missing elements of the standard plan. In addition to the existing list of strategic outcomes, it requires a set of outcome performance measures, departmental activities, and quantifiable outputs. The earlier 1st FSM SDP provided just such a document and provides a good template of what is required. The current SDP indicates that these requirements are to be developed through the preparation of state-level SDPs. However, this Review takes the position that the FSM SDP should clearly establish the planning framework, while state-level SDPs tailored to state requirements can follow thereafter The process of fulfilling these requirements will require significant donor technical assistance (TA), as was the case with the earlier FSM SDP, which involved experts contracted through an ADB TA to prepare sector chapters, as well as a macroeconomic coordinator.

22 FSM Government, *Strategic Development Plan, 2004-2023, The Next 20 years, Achieving Growth and Self-Reliance*, Palikir, Pohnpei, December 2004. The Graduate School team assisted in the preparation of this document.

23 This approach is consistent with a "performance management" approach and provides the framework for the annual budget.

6. State-Owned Enterprise (SOE) Performance and Reforms

The Power Sector

Lack of adoption of full cost- recovery pricing in the utility sector in each state has led to inefficient operations. The FSM has managed to operate the SOE sector without the need for large subsidies. However, weak pricing policies in the utility area have led to inefficient operations and a lack of replacement of capital. In Chuuk, the Public Utility Corporation underwent a comprehensive reform program and now has 24-hour daily supply of electricity and an improved sewer and water treatment system. However, it continues to be important that the Chuuk utility continues its focus on sound management, maintains its reform stance, and avoids any reversal toward poor practices that led to disastrous results in the past.

However, while Chuuk underwent a comprehensive reform program Pohnpei Utility remains in a stressed position. The power situation in Pohnpei unfortunately provides an example of a weakly operated utility, mostly due to the restrictions placed by the state legislature over long periods of time that set prices below full cost recovery. This has resulted in poor maintenance and lack of reliable generation capacity. In FY22 of the 7 generators[24], 3 were not in commission. There was 11,000 kw of installed capacity but it was downgraded to 9,000 kw. This was supplemented through an independent power producer (IPP) with PetroCorp for 2,000 kw, which has also been downgraded to 1,400 kw. In addition, there are numerous installed small solar systems. The available capacity for FY22 fluctuated between 4,300 kw to 7,000 kw with a peak demand of 6,430 kw. The mismatch between demand and supply has resulted in frequent power outages. PUC reports that *"power has improved significantly; however, from time to time it is relatively unstable with several power outages per week, and total system blackouts are not unusual. The power distribution system is relatively old and is due for replacement."*

Pohnpei State utilizes 20 percent revenue share to subsidize utility tariffs. Pre-COVID, a reform plan was prepared to reform the ailing utility along the lines of the Chuuk reform. The initiative proposed a jointly financed reform program with funding from the World Bank, the Asian Development Bank, and the US. However, while widely accepted as a sound basis for reform, the plan was not implemented. More recently Pohnpei agreed with the National Government that the 20 percent revenue share allocated to the states by the FSM Congress could be used as a subsidy to PUC. This led to reduced tariffs from the start of 2023 and well into 2024, which maxed out in June with a reduced tariff of $0.17 kw, well below the unsubsidized tariff of $0.45 kw. The 20 percent revenue share allocated to the states was repealed in FY23 and the subsidy is no longer available.

While no comprehensive reform program has been adopted, a series of other initiatives are underway that will improve the situation of the Pohnpei state utility. It is understood that a full cost recovery tariff has been prepared by an external contractor and, if adopted by the utility, should provide the basis for

24 Pohnpei Utilities Corporation; *Financial Statements, Additional Information and Independent Auditor's Report, Year Ended September 30, 2022*; Pohnpei, FSM.

World Bank reforms have met with resistance by the national telecom provider and duplication of infrastructure.

improved and sustainable operations. It is also understood that the World Bank will be financing a set of 3 new 2,500 kw generators, which should enable PUC to operate without load sharing. There are various other projects and reforms under consideration along with plans for hydro and solar battery systems. However, the grid remains in need of upgrade and renovation, and while the utility places a tariff on water, there are no charges for sewer. In effect, power operations cross-subsidize water and sewer. There is thus a long road ahead before PUC can efficiently provide the service required in the state.

Telecom and Information and Communication Technology (ICT) Reforms

The World Bank has been supporting FSM-led reforms to the ICT market through a series of nationally legislated reforms and the provision of grants. The initial phase of this project included the installation of a $47.5 million fiber-optic connection to Yap and Chuuk, which are now fully operational. The reforms also included the introduction of a new law in 2014 that allowed competition in the ICT market, the establishment of a Telecom Regulatory Authority (TRA), and the creation of an Open Access Entity (OAE) to own and operate the new fiber network. These components have been successfully operationalized, with the TRA issuing relevant regulations. The reform process aims to provide open access to the fiber network for all potential service providers, thereby fostering a competitive market.

Resistance from the incumbent telecom provider has hindered the progress of FSM's ICT reforms. While progress has been made, the project has been fraught with issues and resistance to reform. An initial lack of agreement on the terms of access to the existing HANTRU cable owned by FSM Telecom (providing access between Pohnpei and Guam) was eventually resolved through the issue of an Indefensible Right of Use, guaranteeing the OAE access to the HANTRU cable at no cost. Clearly, the most efficient and effective solution is ownership of all submarine cables by one entity.

A joint project funded by Australia, Japan, and the US invests in the East Micronesian Cable System to provide connectivity to Kosrae. Further funding under a World Bank regional project known as the East Micronesian Project was designed to connect Kiribati, Nauru, and Kosrae to the Pohnpei HANTRU spur. An RFP was issued for the project, but issues arose with the use of Huawei equipment by the selected (lowest bid) vendor, and the bid was canceled. The World Bank dropped out of the project, which was then taken up by a consortium of donors: Australia, Japan and the US. A new RFP was issued, and NEC has been selected as the provider of the cable and installation. The project is on-going, with the marine survey complete, and the first landing station constructed in Pohnpei. Additional landing stations are planned for Kosrae, Nauru, and Kiribati, with the project expected to be completed by the end of 2025.

The World Bank has also initiated the Digital FSM project, though it has encountered further resistance from FSM Telecom. A further World Bank IT project agreed upon by the board in March 2020 and known as Digital FSM ($30 million) is designed to enhance internet use in education and health, promote eGovernment, and provide fiber connectivity to the main locations in the FSM to home/premises. The fiber infrastructure will be owned and maintained by the OAE and available for use by all internet service providers (ISPs). The fiber will be climate resilient and laid below ground. To compete with the OAE, FSM Telecom has laid fiber (above ground) to most home/premises on the main island of Yap and is connecting premises in Pohnpei. The main island Weno in Chuuk lagoon already has fiber connectivity to the home/premises. In the case of Kosrae the OAE has purchased a StarLink community gateway and internet connectivity is being provided through the existing FSM Telecom phone system. When the East Micronesian system comes online it will replace the StarLink community gateway. Kosrae has indicated it does not support infrastructure duplication and FSM Telecom will be required to purchase access through OAE infrastructure. At the present time the World Bank project has yet to break ground and start laying fibre. While the World Bank project is running behind FSM Telecom, the actions taken by FSM Telecom duplicates efforts and defeats the objective of a centralized wholesale service provided by the OAE.

The FSM needs to rationalize the ongoing disputes and inefficient duplication of resources within the ICT market. While the government has established an ICT environment conducive to the widespread adoption of modern ICT services, the incumbent provider continues to resist the reforms. The creation of the OAE as a wholesale provider and the passage of legislation permitting competition and regulation set the foundation for a competitive and regulated market. However, resistance from FSM Telecom, which argues that the FSM is too small for multiple providers, has led to delays, legal cases, and unnecessary duplication of infrastructure. The FSM government should fully support the ICT project, streamline infrastructure use, embrace the changing environment, and focus on providing efficient, competitive services to consumers in the FSM.

FSM PetroCorp and Coconut Products for Export

FSM PetroCorp is an example of a well-managed State-Owned Enterprise (SOE). The FSM PetroCorp was created in 2007 to take over the operations of the departing supplier, Mobil. The transfer was successful, with PetroCorp achieving an annual return on capital of 13 percent between FY10 and FY17, exceeding its original target of 10 percent. From FY18 through FY23, financial performance weakened and PetroCorp recorded an average return on capital of 3.2 percent. Some of this period was affected by COVID and a rise in global energy pries during the early stages of the war in Ukraine. International freight costs rose significantly and PetroCorp absorbed part of the fuel price increase to stabilize prices in the domestic market. However, long-run profitability has been declining; this has resulted from an increasing capital base, including capex in the coconut venture, and a largely static level of operating profits. PetroCorp has diversified operations to Guam and Nauru and is a welcome case of a consistently well-run SOE.

PetroCorp's mandate has expanded beyond fuel into coconut products and renewable energy. Two recent acts of the FSM Congress have diversified the original mandate of PetroCorp. The first is the Coconut Tree Act, PL #18-68 of 2014, which transferred the operations of the former Coconut Development Authority to PetroCorp with the mandate to (i) manage manufacturing, processing, and distribution of biofuel from coconuts, and (ii) better facilitate the processing of copra and other coconut tree products (the former mandate of the CDA). The second major change in its operations was enacted in law

PetroCorp has performed well; however, the coconut venture is high risk and may have led to deterioration in profitability.

through the "Transformation Act", PL #22-171 of 2023 to transform the business model from a successful fossil-fuel importer into an energy company and expand its business activities into renewable sources of energy.

Diversification into copra processing represents a high-risk venture. As a result of the Coconut Tree Act, PetroCorp is expanding operations horizontally through the opening of a coconut processing facility in Tonoas, Chuuk. However, this industry has been in decline for years, impacted by significant out-migration, a declining population, labor shortages, and an aging coconut tree stock. Despite advances in technology that allow for the processing of the whole coconut and the production of virgin oil, the market is dominated by the Philippines, which supplies 70 percent of the world's coconut products at low cost. Clearly, with many economic and financial factors running counter to the establishment of a profitable enterprise, the activity falls under the domain of venture capital. While private sector risk-taking investors might see opportunities where others do not, this is the function of private capital and not normally an appropriate use of public funds.

PetroCorp should reconsider its diversification strategy and focus on energy while it begins paying dividends. While the transition toward providing low-cost, carbon-free energy as outlined in the Transformation Bill is a positive move, the new mission to export high-value agricultural products requires reassessment. One justification for diversification was the anticipated end of economic assistance under the amended Compact and the need for alternative development areas to fill the gap. However, with the Compact renewed on favorable terms, the need to pursue risky ventures to provide uncertain employment opportunities no longer exists. The FSM's significant depopulation—likely over 20 percent since the 2010 census—and recent labor shortages suggest the original assumptions driving the diversification plan are now outdated. This Review recommends that PetroCorp's strategic plan be modified to replace the objective of exporting high-value agricultural products with a focus on its core energy business and the start of dividend payments. While this may seem radical in the context of the FSM, well-functioning SOEs globally are expected to pay dividends as a return on public capital.

To evaluate performance, PetroCorp should provide disaggregated information in the annual audit on the coconut project. In the interests of transparency and accountability, it is important that information about each PetroCorp project (cost center) be separated in its financial statements. Public-audited information should identify cross-subsidization, and each discrete business activity should be carefully monitored to show its true costs In particular, the financial impact of the coconut project on PetroCorp's declining return on capital should be clearly identified and reported.

7. Private Sector Developments

The World Bank's "B-READY" Survey

Although the World Bank's "Doing Business" survey has been discontinued, it painted a discouraging view of the environment for private sector growth in the FSM. The World Bank's ease-of-doing-business survey has now been discontinued due to certain weaknesses in the conduct of the survey[25]. However, the survey provided a useful broad indicator and yardstick on the attractiveness of the business environment. From the 2020 DBS survey, out of 190 countries, the FSM ranked 158 (83 percent down the list), indicating much room for improvement. The FSM fares slightly worse than Palau and the RMI, which are ranked at 145 and 153 respectively, and the FSM is substantially below most of the South Pacific nations. Samoa is ranked 98, Tonga 103, Vanuatu 107, Fiji 102, and Papua New Guinea 120. Overall, the FSM's scores are generally weak. In the areas of registering property, protecting investors, and enforcing contracts, the FSM's scores rank between 184-187, which are some of the worst scores of all countries surveyed by the World Bank. Slightly higher up the list, the FSM registers its best score (65) for trading across borders and its second-best score (104) for obtaining credit.

The World Bank should be encouraged to extend the new B-READY business survey to include the FSM. While the World Bank's Doing Business survey has been discontinued, the survey is being replaced with a new survey titled B-READY, intended to measure the business and investment climate of 180 countries annually. The new survey has already been conducted in 50 jurisdictions with the intention of adding a further 58 in 2025 and 66 in 2026, although the list of countries does not include the FSM or other Freely Associated States of the Marshall Islands and Palau. Enlargement of the B-READY survey to cover the FAS should be encouraged; it enables the three FAS and FSM to benchmark their performance against their peers and form the basis of a roadmap for future private sector reforms.

25 *"The World Bank's Doing Business Report"*, Congressional Research Service, October 29, 2021, Washington D.C.

Foreign Direct Investment

Efforts to reform and streamline the foreign investment regime have run up against state-national jurisdiction issues. The existing Foreign Direct Investment (FDI) regime in the FSM was established as part of a set of reforms sponsored by the ADB in the late 1990s. The FDI regime provides for a two-part system that divides jurisdiction for investments between the National Government (for investments of a national character) and the State governments (who handle all other investments). However, this system is cumbersome and results in a complex licensing process. In 2016 and in 2017 further reforms were introduced in the FSM Congress to modify the 1997 FDI Act, bringing all foreign investment under the jurisdiction of the National Government[26]. These reforms claim that all foreign investment is, by its very nature, of a national character. While the reforms would streamline the FDI process

26 See Congressional Bills, #19-149 and #20-33.

The regulatory environment for Foreign Direct Investment is unattractive and in need of reform.

and should be supported, they have failed to pass through Congressional committee review to be considered for enactment. Changing jurisdiction in an area formerly under state control will take considerable effort.

Private Sector Assessment

The FSM should consider commissioning a Private sector Assessment to provide a framework for future reform. While the focus in the FSM has recently been on the renewal of the Compact and adjustment to the new fiscal procedures, there has been a lack of focus on how to improve the enabling environment for business and support for inclusive economic growth led by the private sector. In both Palau and the Marshall Islands, the ADB through the regional financed Private Sector Development Initiative based in Sydney, has prepared informative and benchmark studies on the environment for the private sector[27]. The studies are comprehensive and include a discussion on topics such as:

- Issues facing the private sector
- Agriculture, fisheries and tourism
- Land
- Access to finance
- Commercial legal and regulatory framework
- Foreign Direct Investment
- Tax policy
- State-Owned Enterprises

With the renewal of the Compact on favorable terms and an assured financial framework for the next 20 years, the timing is appropriate to focus on the FSM's private sector to accelerate the growth and development of the nation. Commissioning PSDI to undertake a benchmark study and Private Sector Assessment would be a good way to start.

27 See for example, ADB, Private Sector Assessment for Palau Policies for Sustainable Growth Revisited, 2017, Sydney, Australia.

8. The 2023 Amended Compact

Background

The original Compact of 1986 was extended in FY04, known as the 2003 Amended Compact (C-03), for a further 20 years. Negotiations for the original Compact of Free Association between the FSM and US began in 1980. A plebiscite was held in 1983 and a majority of the FSM confirmed the desire to enter into the Compact of Free Association. The original Compact, which became effective in 1986, was for a 15-year period with a two-year extension through the end of FY03. In FY04, the Compact was extended for a further 20 years through FY23, known as the 2003 Amended Compact (C-03). C-03 contained funding for a series of annual sector grants, supplemental education grants, support for audits, disaster assistance, and funds for a Compact Trust Fund (CTF).

The terms and conditions of the 2023 Amended Compact (C-23) were agreed in principle by the US and the FSM in January 2023 and became law on March 9, 2024. In January 2023, an initial agreement detailing the basic financial assistance to be granted to the FSM was agreed upon between the US Special Presidential Envoy for Compact Negotiation and the FSM Chief Negotiator. However, the agreement awaited passage by both houses of the US Congress. Fortunately, on March 6, the US House passed bill H.R. 4366, including mandatory funding for all three FAS Compact amendments. The US Senate passed the same bill on March 8, and the US President signed the bill into law on March 9, 2024. With the law enacted, a period of rapid mobilization involving both the US and FSM governments followed to achieve "entry-into-force" in a timely manner. Temporary funding that had been provided by the US government for the period from October 1, 2023 – March 8, 2024, was deducted from the grants to be provided under the new arrangements.

The 2023 Amended Compact

There are a series of important instruments that outline the new agreement between the US and the FSM: changes in the Compact law (Public Law 118–42), the Fiscal Procedures Agreement (FPA), and the Trust Fund Agreement (TFA). These documents are interrelated and lengthy, and the implications have not been fully worked out. The following discussion describes the main features of C-23 as negotiated and enacted.

Direct Economic Assistance

Sector grants

C-23 provides an annual grant for 20 years of $140 million for sector grants but without an adjustment for inflation (see discussion below). The sectors (see section 261(a) of the Compact law) include the original list, with some additions and modifications:

- Education: including those services previously undertaken under the Supplemental Education Grant (SEG).
- Health
- Private Sector Development
- Capacity Building
- Environment
- Public Infrastructure ,with the proviso that priority is to be accorded to the social sectors and an extended list of infrastructure projects (compared with C-03) that directly affect health and safety, including water and wastewater projects, solid waste disposal projects, health care facilities, airport and seaport improvements, roads, sea walls, and energy development, including renewable energy. A minimum of 25 percent of a three-year moving average of the total value of the sector grant total is to be awarded to infrastructure.
- Enhanced Reporting and Accountability: This shall be no more than 2 percent of the total sector grants awarded.

> *2023 Amended Compact comes with a significant increase in grants.*

Infrastructure Maintenance

The US government will make an initial contribution to the Infrastructure Maintenance Fund of 7 percent of the annual sector grant of $140 million in FY24. Thereafter, the US will increase the annual grant by an adjustment of approximately 1.9 percent per annum. The FSM may contribute to the IMF should it so wish. The funds may only be used to repair or maintain infrastructure provided by the US.

Annual Audit

The cost of the annual audit will now be borne by the Government of the FSM and come out of the total sector grants available. In C-03 a grant of $0.5 million was provided for this purpose.

Disaster Assistance Emergency Fund

The DAEF was initiated in C-03 with a fixed annual grant of $200,000. The fund continues under C-23, with funding to be come out of the $140 million sector grant.

Unspent Sector grants

Treatment of unspent economic assistance grants under C-23 has changed and the former "carry-over" funds will no longer exist. Unspent sector grant funds remaining at the end of C-03 other than the infrastructure grant will be deposited into the CTF as a contribution from the FSM. Large unspent C-03 infrastructure funds will also be deposited into the CTF, but will be available for use by the FSM until FY44 when they will be deposited in the CTF as a contribution of the FSM.

During the C-23 period, all unspent and unobligated non-infrastructure funds will at the end of each year be deposited in the CTF as a contribution from the FSM. In the case of infrastructure funds, these will be available for use by the FSM for infrastructure projects until the end of FY43 when they will be deposited into the CTF as a contribution of the FSM.

Federal Programs and Services

The US government will continue to provide access to US Federal Programs and Services as agreed upon in the original Compact. Federal services included but are not limited to:

- US Weather Service;
- US Postal Service;
- US Federal Aviation Administration;
- US Department of Transportation;
- Federal Deposit Insurance Corporation; and
- Federal Emergency Management Agency.

Joint Economic Management Committee - JEMCO

The nature and powers of JEMCO have been modified since it was originally specified in C-03. In its current form, JEMCO is composed of a US chairperson, two other US members, and three members from the FSM. The FPA indicates that decisions shall be made by consensus. If consensus cannot be reached, decisions are to be made by majority vote, and in the event of a tie, the US chair will cast the deciding vote.

The major duties of JEMCO are to review the:

- Strategic Development Plan (SDP);
- Infrastructure Development Plan (IDP);
- Annual Implementation Plan (AIP);
- Annual Financial Report;
- Annual Performance Report;
- Annual Financial Audit; and
- Annual Trust Fund Investment Reports.

Provided the FSM has satisfactorily submitted the SDP, IDP, and AIP in the format and detail required, with conforming sector allocations, JEMCO is required to review and concur. It can only reject proposals if they do not meet the conditions specified in the FPA. The role of JEMCO has thus changed from *ex-ante* approval to a greater focus upon *ex-post* review of the annual financial and performance reports as discussed below.

Pre-Award Requirements

Strategic Development Plan

The Compact law states that the Government of the FSM is required to prepare and maintain an official overall development plan. The plan is to be strategic in nature and continuously reviewed and updated through the annual budget process and shall make projections on

2023 Amended Compact comes with a significant increase in pre- and post-reporting requirements, including performance monitoring.

a multi-year rolling basis. Each of the sectors eligible for sector grant funding are to be accorded specific treatment in the plan.

In addition to the requirements in law, the FPA requires that the SDP must include:

- The goals and broad strategies of the Government of the FSM to promote economic advancement, macro-economic goals, budgetary self-reliance, and economic self-reliance;
- Specific multi-year objectives for each of the eligible sectors, and
- A certification that the Strategic Development Plan has been formally adopted by the National Government of the FSM.

Infrastructure Development Plan

The IDP is to provide a list of infrastructure projects that will be used to guide the selection and use of the infrastructure grant. The IDP is required to be consistent with the goals specified in the SDP.

Annual Implementation Plan

The FSM is required to provide by July 15 of each year an annual implementation plan (AIP or budget) to JEMCO that compiles and details proposed uses of grant expenditures. The AIP is required to indicate:

- Proposed sector allocations;
- Actual expenditures in the most recently completed fiscal year;
- Appropriated grants in the current fiscal year;
- Proposed expenditures for the upcoming fiscal year by program and ministry portfolio, including a detailed breakdown of object classes; and
- Objectives, specific performance indicators, and assessment methods.

Post-Award Requirements

Financial Reports

Quarterly and annual financial reports are required to provide:

- Statement of revenues and expenditures by fund types with a comparison of budget and actual expenditures by function and fund types;
- A report for all operational grants by function and major offices, cost centers, and budget activities, and
- A fund status report on the Health Care and Climate Funds that shows deposits, disbursements, and fund balances.

Monitoring and Performance Reports

A new feature of C-23 is the requirement for the FSM to monitor and provide performance reports. Ongoing monitoring is required to ensure program execution is in accord with achievement of the performance goals. The annual performance report is required to provide a comparison of actual accomplishments with the objectives and indicators established in the implementation plan.

C-23 requires that budget execution is undertaken on a performance basis. However, the FPA fails to distinguish between outcomes/results and program outputs/deliverables. The same issue failed to be addressed adequately during C-03 with the US focusing upon outcomes and the FAS focusing upon project outputs or deliverables.

Third-party assistance

Recognizing the challenges the FSM faces in compiling the required financial and performance reports, the U.S. has required the FSM to retain a qualified third party to assist. However, the choice of the third party requires consultation with the US. The responsibilities of the third party will be to:

- Assist in collection of the necessary material;
- Assist in analysis;
- Draft the reports, and
- Provide training and capacity building.

The FPA does indicate that in many cases material will not exist or be available to provide the information necessary to prepare the performance reports. In these cases, it will be necessary to develop data systems to provide the information that can best be used for monitoring and performance assessment.

Compact Trust Fund

Repurposed Trust Fund

The CTF agreement has undergone a signif`icant overhaul. The original objective was to provide a source of funds to replace the sector grants at a level consistent with the value of the sector grants at the end of C-03. However, under C-23, the CTF has been "repurposed" to augment the revenue available to the FSM immediately, rather than only after FY43. Additionally, the agreement includes a provision allowing the parties to mutually agree to continue the sector grants beyond FY43 on the same terms as those outlined in C-23. This change implies that the original objective of the CTF—attaining a level sufficient to generate returns to replace the annual sector grants—is no longer required. This issue is discussed further below.

New CTF contributions

In C-23 the FSM negotiated to replace the 2 percent annual adjustor (the provisions provided to the RMI and Palau) with two contributions into the CTF of $250 million in FT24 and FY25. The FSM will withdraw funds from the CTF to maintain the real level of the annual sector grants.

A New Account Structure

The 2023 amended Compact replaces the original A, B and C accounts of the CTF, with three new accounts 1, 2 and 3. Account 1 takes on the functions of the A, B and C accounts of C-03 and holds the corpus of the CTF. Account 2 is a holding account where funds to be disbursed are held, but are returned to Account 1 if undisbursed at the end of each year. Account 3 is a holding account for unspent economic assistance primarily from the infrastructure grant and can be withdrawn by the FSM for eligible purposes.

Trust Fund Committee

The Trust Fund Committee serves as the Trustee of the Fund in accordance with the provisions outlined in the CTF Agreement. The Committee consists of three U.S. members, one of whom serves as the chair, and three members selected by the FSM. Decisions by the Trust Fund Committee are made by majority vote, with the chair holding the deciding vote in the case of a tie.

Compact Trust Fund is restructured to allow for an annual inflation adjustment during C-23 and annual sector distributions after FY43.

An important element of C-23 is that the Trust Fund Committee assumes responsibility for the use and allocation of distributions as outlined in the CTF Agreement and FPA that have otherwise been reserved for JEMCO. This is an unexpected provision to allocate decisions relating to the use of sector grants for government operations to a committee that has otherwise been focused on fiduciary responsibilities.

Distributions

The new CTF provisions allow for four types of distributions:

- Sector Distributions
- Resiliency Distributions
- Special Needs Distributions
- Unspent Economic Assistance Distributions.

Sector Distributions are for CTF distributions post FY43. These distributions are estimated through a complex set of formulas involving a three-year moving average of the CTF corpus, along with a system of 10-year moving average estimates of the CTF's historical market rate of return. The calculation is adjusted by a sustainability gap adjustment, which is set at 5/6ths of the corpus but can be varied by the Trust Fund Committee between 4/5ths and 9/10ths.

Resiliency Distributions are designed to ensure distributions equivalent to the full inflation adjustment of annual sector grants ($140 million) after FY23, based on the increase in the U.S. GDP deflator. These distributions are capped at 4 percent of the three-year moving average of the CTF corpus.

Special Needs Distributions are reserved for unforeseen expenses in the FSM, such as projects that cannot reasonably be financed from other sources. These distributions are likely intended to cover emergencies like climate-related disasters, sea-level rise, or pandemics such as COVID-19. Withdrawals are limited to 2 percent of the three-year moving average of the CTF corpus.

Unspent Economic Assistance Distributions are for withdrawal of unspent infrastructure funds and are capped at the total amount of funds deposited in Account 3.

Trust Fund Sustainability

Under the 2023 Trust Fund Agreement, the FSM has chosen to accumulate all trust fund earnings in the CTF through FY43. Unlike the Marshall Islands and Palau, drawing on the FSM CTF during the C-23 period for operational or investment and growth purposes is prohibited. Allowable withdrawals during C-23 are limited to inflation adjustment of the sector grants, use of prior unspent infrastructure funds or periodic unforeseen purposes. In the case of the Marshall Islands, the government intends to withdraw the maximum available funds to support a universal basic income. For Palau, it is also able to withdraw funds from the CTF, although use of the funds for either operational or investment purposes has yet to be decided. The FSM, however, has self-imposed the condition to accumulate and save resources in the CTF for use after FY43.

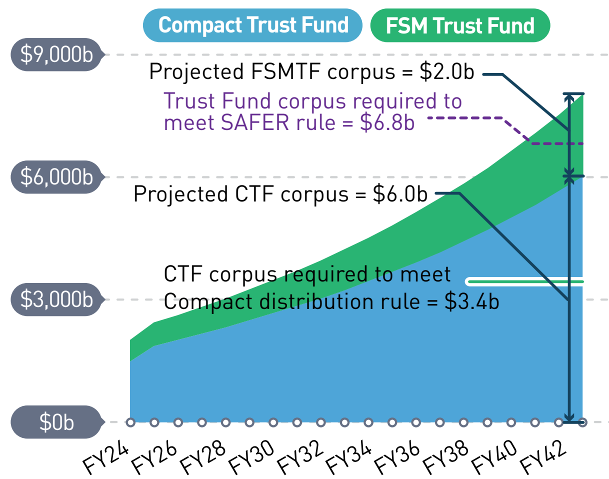
The decision to "cash out" the 2 percent annual adjustor presents risks. An issue arising for FSM, however, concerns the cash out of the 2 percent annual adjustor in favor of an upfront fund of $500 million to fund inflation adjustment. The C-23 agreement indicates that the parties may mutually agree to extend the Compact on the same terms and conditions as agreed post C-23 in FY44. However, at this point the FSM will only be entitled to the annual nominal sector grant level of $140 million without any funds for annual adjustment other than the original $500 million. Long-term projections suggest that while the $500 million will suffice for the FSM through C-23, these funds will be exhausted after more than 20 years.

Projections indicate that the CTF should, on average, be able to replace the annual sector grants in FY44, adjusted for inflation. Starting in FY44, the FSM will be entitled to withdraw up to the long-term rate of return on the CTF, calculated using a three-year moving average of the CTF corpus, with an adjustment for sustainability set at 5/6ths (or 83 percent). At this rate of withdrawal, the real value of the distributions and the CTF[28] corpus will decline, leading to an unsustainable withdrawal rate, which contradicts the objective of the sustainability gap adjustment. However, after 20 years of accumulation (with the exception of annual withdrawals for inflation adjustment), there will be sufficient funds to maintain distributions equivalent to the real value of the FY24 sector grants adjusted for inflation. This situation is illustrated in Figure 20, which shows that the projected CTF value of $5.6 billion will be above the average rate of return needed to sustain distributions.

At current funding levels the CTF will not be able to provide distributions of sufficient magnitude with a high degree of certainty. However, the above simple measure of sustainability does not account for market risk. Simulations of the CTF provisions in C-03 for the FSM propose a sustainability adjustment (known as the SAFER rule) of 60 percent of the real rate of return[29]. It is important to note that the SAFER adjustment is significantly higher than the C-23 sustainability gap adjustment. At the SAFER rate, simulations show the level of distributions that can be sustained with a high degree of confidence (95 percent). These estimates are based on Monte Carlo simulations of historical market rates of investment yield and inflation. Figure 20 indicates that under the SAFER rate, the CTF will not have achieved sufficient level to ensure real distributions at FY44 levels with a high degree of confidence. However, combining the FSM and COFA funds will result in a combined value of $7.6 billion, which will be adequate to meet this objective[30].

Figure 20: Compact Trust Fund sustainability

CTF corpus will meet Compact distribution rule but not SAFER



28 Based on a historical average rate of return on a balance portfolio of 7.3 percent and an average inflation of 2 percent.

29 See earlier GSUSA FSM annual Economic Reviews and definition of the Sustainability Adjustment for Enhanced Reliability (SAFER).

30 These results indicated here are preliminary and the GS CTF simulation model would need updating to validate the results.

9. Special Topics

Structural surplus and contributions to the FSM Trust Fund

The favorable outcome of the 2023 Amended Compact prompts a discussion on the optimal use of the FSM's own trust fund resources. The boom in sovereign rents has enabled the FSM to accumulate significant resources in the FSM Trust Fund (FSMTF). These funds were initially set aside to support the FSM in case the Compact renegotiations yielded a less favorable result. Additionally, the FSMTF is designed to support the country in the event of climate change-related emergencies or other national crises. With the positive outcome of the C-23 provisions and the FSM's decision to allow the CTF resources to accumulate until FY44 (excluding inflation adjustments), the CTF is expected to be sufficient to replace the inflation-adjusted sector grants post-FY44 under average conditions, although not with a high degree of certainty. This suggests that the FSM should continue to allow the resources in the FSMTF to accumulate until the combined funds, from both the CTF and FSMTF, reach a level that provides a reliable yield to replace the sector grants with confidence.

The purposes of distributions from the FSMTF are broadly defined but are prohibited until 2030. At the end of FY23 the FSMTF had accumulated funds in excess of $525 million with $75 million held on behalf of the State governments. Under present FSM laws PL 19-67 and PL 320-185, no funds may be withdrawn until 2030, after which withdrawals will be allowed at a rate of 5 percent per year, provided this does not erode the real value of the fund. At its current level, a 5 percent withdrawal could generate up to an additional $25 million in resources. The stated purposes of the FSMTF are as follows:

1. Assist the National Government and other participating governments to achieve greater financial autonomy in the management of their recurrent budgets;
2. Enable the FSM at all levels of government to meet long-term maintenance and operating costs of social and economic infrastructure; and
3. Enable the FSM at all levels of government to improve existing levels of social and economic infrastructure.

The successful renegotiation of C-23 suggests it may be time to revisit the purposes of the FSMTF. Originally, the purpose of withdrawals from the FSMTF was to supplement shortfalls in Compact sector operating and infrastructure grants. However, with the provisions of C-23 partially addressing these needs, they may eventually become unnecessary. Should this occur, FSMTF resources could be redirected to fund development projects, programs, and economic growth, rather than government operations. The potential to allocate resources at both the national and state levels through a robust project evaluation process—ensuring funds are directed towards well-designed projects rather than politically motivated ones—suggests that it would be beneficial to

The failure to fully utilize the available Compact grants for infrastructure contributed to weak economic performance during C-03 and needs improvement if the FSM is to live up to its potential.

reconsider the purposes of the FSMTF at an appropriate point in the future.

Infrastructure and the Economy

By the end of FY22, unused Compact infrastructure resources had accumulated to $305 million, representing 74 percent of GDP. Initially, the implementation of Compact infrastructure grants was slow due to capacity constraints. However, by FY12, these challenges had been addressed, and expenditures rose to $27 million, surpassing the allocated $22 million. This improvement was short-lived, and a series of issues hindered further implementation, with utilization dropping to just $4.6 million in FY22[31]. Out of a total estimated allocation of $457 million for infrastructure from the start of the amended Compact through FY22, the FSM was only able to utilize approximately $152 million, leaving $305 million (74 percent of GDP) in unspent resources.

The delays in utilizing the infrastructure grants have been costly for the FSM economy, resulting in lost opportunities and slower growth. After adjusting to the new conditions under the amended Compact, the economy performed relatively well, supported by greater use of the infrastructure grants and FAA airport improvement projects. However, from FY12 to FY14, as construction demand decreased, the economy contracted by 8 percent. While much of this decline can be attributed to the completion of large FAA airport improvement projects, a significant portion was due to the reduced use of the infrastructure grants, highlighting the critical role these funds play in stimulating the economy.

The backlog of unspent funds, along with provisions from C-23, offers a major opportunity for improvement in both infrastructure and the FSM's growth and development prospects. C-23 allocates 25 percent of the annual grant stream—equivalent to $35 million—to infrastructure, a significant increase compared to the C-03 provisions. Combined with the unspent C-03 funds of $305 million, this results in a total of $1 billion in infrastructure funding at today's prices. These resources can not only support the FSM's infrastructure and development but also provide a significant boost to economic growth and demand. It is crucial to move past the historical differences between the U.S. and FSM at JEMCO and adopt a collaborative approach to efficiently and effectively utilize available infrastructure resources.

A new Infrastructure Development Plan is needed to guide investment decisions during C-23. This plan should ensure a phased, macroeconomic approach to infrastructure development, avoiding the boom-and-bust cycles that have plagued the FSM in the past. If the investment program is not completed by FY44, the funds will revert to the CTF, resulting in a significant loss to economic development and growth.

Statistical Issues

The FSM 2023 Population Census indicates significant depopulation and out-migration. A key statistical concern is the delayed release of the recent FSM population census data. The census, conducted in 2023, revealed a substantial reduction in population compared to 2010 levels, with figures falling far below projections. While significant out-migration was expected, the extent of the depopulation was much greater than anticipated. For example, in the Marshall Islands, the population decreased from 53,000 in 2010 to 42,000 in 2021, a 20 percent reduction. Initial estimates for the FSM suggest an even greater 25 percent reduction. The FSM Division of Statistics has been working to validate the results by cross-referencing immigration and tax records, but access to this data has been limited. Given the similarity to trends observed in other Micronesian nations, preliminary

31 Latest audited information is for FY22.

> *The failure within the National Government to share information has resulted in the loss of GDP statistics and urgently needs attention.*

data should be made public with appropriate caveats, although the 25 percent reduction warrants careful verification.

The termination of data sharing between the Department of Finance and Administration and the Statistics Division has created challenges for compiling economic data. Since FY16, the Department of Finance and Administration (DOFA) and the Statistics Division of the Department of Resources and Development (R&D) have not shared information, despite a long-standing history of cooperation[32]. Data sharing between the two entities had been the norm since the early 2000s, supported by a Memorandum of Understanding (MOU) that ensured the confidentiality of the information shared. The confidentiality of proprietary data collected by the Statistics Office was further protected under the Statistics and Census Act PL 5-77 of 1988.

The termination of data sharing was justified by the need to comply with OECD and Global Forum requirements on tax information exchange. During the preparation of the FY16 national accounts, DOFA officials stated that they could no longer provide information previously shared, such as the Business Gross Receipts Tax (BGRT) rolls, to the Statistics Division. This decision was made to comply with OECD and Global Forum requirements regarding the exchange of tax information between external jurisdictions. As a result, a critical data source for compiling private sector GDP and GDP by industry was effectively cut off. However, while the OECD protects the exchange of information between jurisdictions, it does not mandate or provide provisions for sharing data within jurisdictions or between government departments.

Although data sharing was briefly resumed, it was again prohibited in 2024, limiting the quality and scope of GDP estimates. In 2023, with support from the then-Secretary of Finance, the MOU between the Statistics Division and DOFA was updated. The FSM Justice Department and Attorney General confirmed the MOU's legal adequacy, ensuring the protection of taxpayer rights and confidentiality. As a result, the necessary information was shared with the Statistics Division, allowing for GDP estimates for FY16-FY22 to be prepared. However, following the 2023 signing of the MOU, a new administration took office and reinstated the data sharing prohibition. Consequently, the Statistics Division is now limited in its ability to produce comprehensive estimates for FY23, as used in this Review. Instead of full GDP estimates, only partial GDP estimates by institutional sector are available, excluding the private sector or the overall GDP aggregate. Furthermore, GDP estimates by industry remain unavailable[33].

The lack of reliable GDP data has had long-lasting implications for the FSM's economic planning and monitoring. The absence of accurate GDP figures hinders the FSM's ability to track economic performance, growth, and development, as well as to effectively formulate development plans. Additionally, the surveillance of the FSM's economy by international organizations such as the IMF is at risk when only incomplete datasets are available. Economic analyses, such as the IMF and World Bank's Debt Sustainability Analysis, become problematic when the debt-to-GDP ratio cannot be measured. This issue has persisted for an extended period and clearly requires resolution.

32 The Graduate School USA and EconMAP have supported the FSM Statistics Division since 2006, assisting with the compilation of GDP, national accounts, and related economic statistics.

33 For this *Review* the GS has used proxy information for estimation of GDP by industry. These estimates are to be considered as provisional only and are not official.

A mini-business survey could be a practical solution to the ongoing data sharing issue. Given the persistent unreliability of data sharing arrangements, the Statistics Division could develop a mini-business survey to capture the necessary data for national accounts compilation. This approach is commonly used in other countries for estimating national accounts. The FSM Statistics Division already operates field offices in each of its four states, which could be leveraged to distribute a simple questionnaire to businesses. This survey could replace the BGRT tax data and be expanded over time. The survey would focus on collecting data from key businesses, allowing the Statistics Division to improve on the former tax data with information more closely aligned to GDP concepts.

10. The Economic and Fiscal Outlook

Assumptions Informing the Outlook

The economic outlook and projections for the FSM are based on the GSUSA economic model: MTEF-mod. This section presents a set of projections for the economy based on the C-23 Compact provisions. The projections are based on the GSUSA Excel-based model of the economy (MTEF-mod), which is based on the standard set of economic accounts: GDP by industry in current and constant prices, employment, generation of income and household account, fiscal account, GDP by expenditure, financing, and price projections. The MTEF-mod provides a baseline scenario through FY30 and enables adjustment of variables to simulate the impact of different assumptions and policies. The assumptions of the baseline are discussed first, followed by the results.

Compact grant availability will grow strongly with sector grant availability of $140 million, including inflation adjustment from FY25. The new level of sector grants of $140 million with full inflation adjustment is a significant increase from the FY23 level, the last year of C-03, of $85.4 million. While there are several offsets requiring deductions, such as audit, disaster assistance of $0.2 million, plus $9.8 million in FY24 for infrastructure maintenance, and former allocations for the supplemental education grant (SEG) which are now provided through the sector grants, the residual is a considerable increase in funds available for sector budgets.

Funds for infrastructure also represent a large increase. Compact resources for infrastructure have grown from $25.6 million in FY23 to $35 million in FY24. Part of the C-03 infrastructure funds remain unspent, over $300 million and are assumed in the model to be drawn down gradually throughout the C-23 period. There is also a large volume of ADB and World Bank infrastructure projects planned for the FSM although whether these projects will continue as grants or loans is not yet clear. In the *Review* these are treated as grants. There is also the Compact infrastructure maintenance program of close to $10 million with an annual adjustor. The impact of these projects is categorized by type, construction, plant, equipment, architectural and engineering design, and phased in over a period of years. There are clearly more projects and resources than the FSM can absorb from the outset, and capacity is programmed to grow slowly.

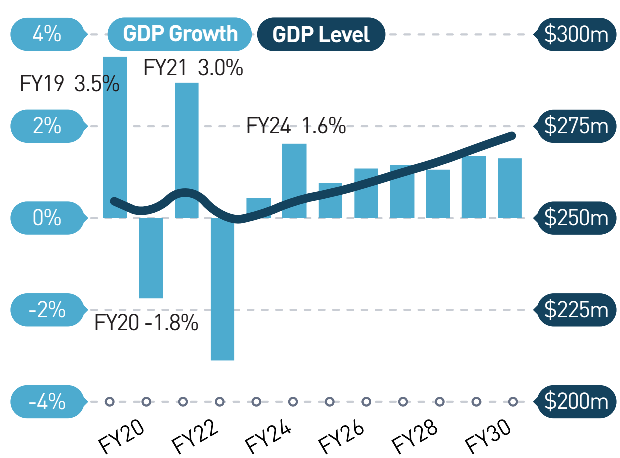
Government expenditure is assumed to gradually increase until it hits the fiscal envelope. The assumptions for State and National Government fiscal policy vary by government, reflecting the fiscal position at the end of C-03 and the FY24 FMIS data. For the State governments, the fiscal position improved considerably in FY23 and FY24, with both an increase in revenues from fishing fees shared 50:50 with the National Government and an increase in Compact operating sector grants. However, by the end of FY24 all state governments had implemented the 45 percent wage increase although the FY24 outturn had yet to fully reflect the increase. For the National Government the fiscal position had turned negative with the loss of the fishing fees and a large overhang of electoral district projects appropriated in earlier years.

The private sector is projected to remain highly dependent on public sector demand with only small changes in fisheries and tourism. Other than the stimulative impact of additional public sector spending and increase in construction activity due to the increase in infrastructure projects, the private sector is expected to continue its dependent nature, supplying goods and services to the public sector. The domestic fishing sector is projected to remain largely unchanged and tourist arrivals to decline marginally, reflecting long-run trends during C-03. Fishing fee royalties are projected to remain stable in nominal terms.

Outlook for the Economy

Economic growth is slow to pick up at the start of C-23. After a weak terminal year FY23 of the 2003 amended Compact, economic growth is projected to pick up in FY24, the initial year of C-23, see Figure 21. However, much of the FY24 improvement reflects the return of the fisheries sector to normal levels of catch after a poor year in FY23. Fisheries contributed 1.8 percent to the 1.6 percent growth in FY24, indicating that the underlying rate of growth for FY24 was negative. The weak underlying growth reflects that the new Compact only came into force halfway through the year, leaving insufficient timing for any adjustment in the second half. The improved result in FY25 reflects the full utilization of the additional resources in the two small states, Kosrae and Yap, and the full impact of

Figure 21: GDP level and projected growth, FY19-FY30
With additional Compact resources and infrastructure spending economic performance is expected to improve



With the large increase in grants for operations and infrastructure, the outlook for FSM economic growth looks favorable.

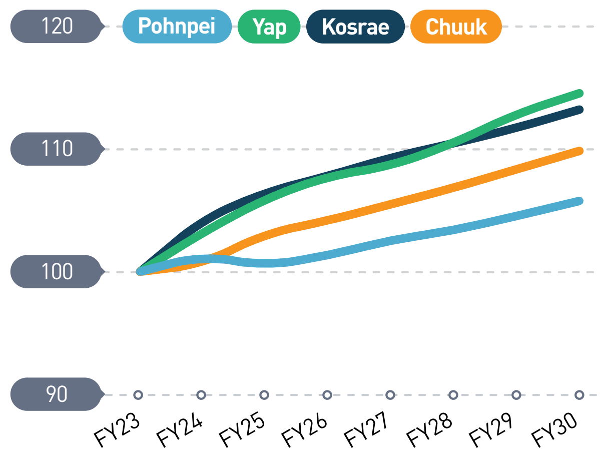
the 45 percent payroll increase in Chuuk and Kosrae. However, both the large states are not assumed to fully utilize all the resources available to them. Construction activity is projected to increase, but mostly from the large backlog of C-03 unused funds. On the downside, a large National Government fiscal contraction is anticipated as it adjusts to the reduced fiscal envelope.

Overall economic performance is projected to improve through the end of the 2020s. The economic outlook for the remainder of the 2020s looks favorable as the FSM overcomes absorptive capacity constraints. While both Kosrae and Yap had fully programmed the new Compact funds in FY24, the projections assume Chuuk and Pohnpei states gradually absorb the additional funds through FY30 with payroll reflecting a slow trend increase. Construction activity is projected to increase in all states as the FSM builds up absorptive capacity. It is assumed the infrastructure management and procurement issues are a thing of the past and a collaborative environment is maintained for implementing the legacy and new infrastructure grants. By FY30 the economy is projected to grow by 1.3 percent, a considerable improvement on the C-03 performance. The baseline scenario presented in this Review is optimistic but well within the bounds of feasibility. It does not assume any significant reform effort that encourages private sector growth and development. The scenario is essentially a public sector growth strategy.

Economic performance is projected to be more equitable in C-23. Figure 22 presents a trajectory of economic performance by FSM state. Kosrae and Yap, reflecting their smaller size, are able to get off to a good start

Figure 22: Economic perfomance at the state level, FY23 = 100

Economic growth is projected to be more equitable in C-23



in C-23, fully absorbing the new Compact resources from the get-go. Yap State growth is likely to be significantly higher due to the military airport redevelopment with reported expenditures in the 100s of millions. In the case of Chuuk, slower adjustment to the new Compact provisions is reflected in a lower trajectory. Reflecting the need for a large fiscal adjustment at the National Government, Pohnpei State struggles in the first few years but then picks up speed. From FY25 onwards, growth in the four states is close, averaging 6 percent for the FSM as a whole over the period. Reflecting the more equitable fiscal distribution between the National and State governments, economic growth is more equitable across the states.

Employment

Enhanced performance in the utilization of the infrastructure grant during C-23 will create a large demand for jobs. The labor-intensive nature of construction will generate a significant improvement in demand of labor. The projections indicate jobs will grow from 14,582 in FY23 as measured from Social Security data to 16,700 jobs in FY30, see Figure

Figure 23: Employment level and projected growth, FY19-FY30
An additional 2,000 jobs are projected to be created by FY30 if better capacity utilization of the infrastructure grant can be achieved

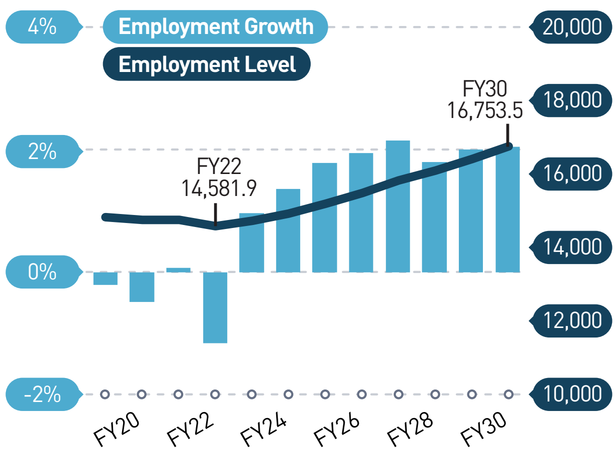
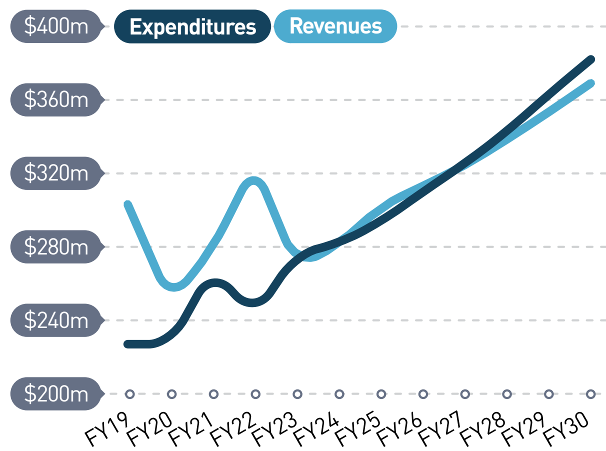


Figure 24: FSM governments consolidated revenues and expenditures, FY19–FY30
After initial surplus at the state level in C-23 FSM fiscal position is projected to be close to balance by FY30



23. This is an increase of 14 percent and an annual average of 1.9 percent. However, it should be noted that the projection indicates the demand for jobs required to fulfill the increased demand for construction. During and after COVID, labor shortages have been noted and it is clear that for skilled construction workers, foreign labor will be required. However, the increased demand will make an important contribution for much-needed employment growth.

Fiscal

FSM is projected to record a small fiscal deficit in FY24. The data for the historical period FY23 and FY24 reflects data as reported through the respective government's FMIS. In FY24 the overall outcome for the FSM is close to balance, with a fiscal deficit of 0.2 percent of GDP, see Figure 24. While the state governments run a fiscal surplus of 4.0 percent of GDP with a large inflow of additional and unspent resources, the National Government runs a matching large fiscal deficit of 4.2 percent of GDP funded by drawdown of prior cash balances. In FY25 the National Government is projected to undertake a significant fiscal adjustment, reducing the deficit to 0.9 percent of GDP. This is achieved by an assumed 10 percent use of Compact sector grants and reduction of electoral district projects to $7 million. During C-03, the National Government elected not to use available sector grants, but following the loss of fishing fees it is understood the National Government will program its 10 percent Compact grant share. Figure 25 displays the fiscal position of the National and State governments during the period through FY30. As indicated, the trajectory anticipates the National Government to sustain a deficit average of close to 1 percent of GDP throughout the period.

For the State governments, the fiscal position is the reverse of the national. The states start

Projections indicate that while the National Government fiscal position will tighten, the states will have additional funds to improve service delivery.

Figure 25: State and National Government Fiscal Position, FY19–FY30
After initial surplus at the state level in C-23 FSM fiscal position is projected to be close to balance by FY30

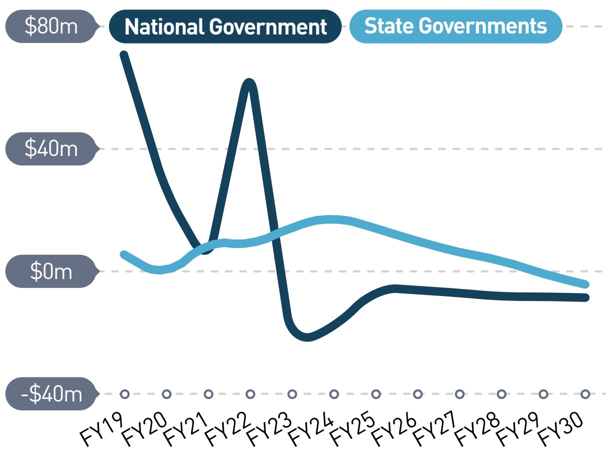
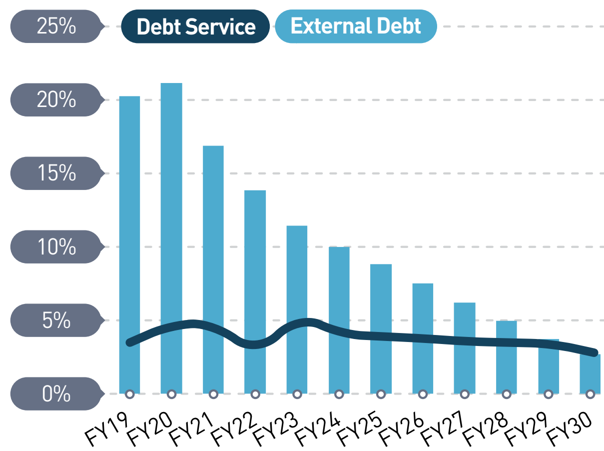


Figure 26: External debt ratios, FY19-FY30
External debt and debt service are projected to fall to very low levels by FY30 assuming FSM adopts zero borrowing policy



the period with a significant surplus although the FMIS data indicates Kosrae and Yap had largely absorbed the additional funds in FY24 with some extra payroll expense due in FY25, reflecting a full year's coverage. For Pohnpei the increased payroll expense is fully covered in FY24 while in Chuuk there is some catch-up in FY25. In both states it is expected that the numbers of civil servants will grow in line with historical trends, and the use of goods and services will expand during the period through FY30 to absorb the fiscal space available. It is anticipated that fiscal balance for the FSM will gradually decline, and a small deficit will emerge in FY30.

External Debt

FSM external debt is projected to fall to very low levels by FY30 although the nation may incur new debt after the loss of "grant-only" status. As noted in the fiscal section of this Review, FSM's external debt had fallen to very comfortable levels by the end of C-03. These trends are projected for the C-23 period. Figure 26 indicates that both debt-to-GDP and debt service as a ratio of government domestic revenues will fall below 3 percent. However, the new debt sustainability analysis (DSA) for the FSM now designates the nation no longer at high risk of debt stress and donor funding will now come in a blend of grants and loans from the multilateral organizations. Sovereign debt in the FSM is incurred by the National Government, which generally takes place at the state level. A process of on-lending to the State governments is required with collateral usually taking the form of a lien on State revenues. This has placed a natural break on borrowing. However, it is probable that the National and in turn the State governments will incur debt in the future if they wish to access donor finance.

11. The Reform Agenda

Progress with Reform

The FSM underwent significant reforms in the late 1990s and early 2000s to adjust to changes in Compact funding. As the original Compact neared its end in the late 1990s, the FSM began a period of reform to address the "second step-down" in annual Compact grant flows. Under the Public Sector Reform Program (PSRP) financed by an ADB loan in 1997, a series of initiatives were launched, including: (i) a 20 percent reduction in civil servant wage costs, (ii) tax reform aimed at enhancing revenue collections by shifting import tax collection to a CIF basis, and (iii) reforms to improve the private sector regulatory environment for foreign direct investment. Following the PSRP, the FSM entered into a Private Sector Development program with the ADB to support economic growth. Key components of this program included: (i) legislation for long-term leases and mortgages, (ii) secure transactions reform, (iii) strengthening the FSM Development Bank, (iv) developing SOE Master Plans, and (v) support for small business development centers.

The 2003 Amended Compact required significant fiscal adjustments, including reductions in government expenditures. The transition to the sector grant approach under the 2003 amended Compact created the need for fiscal adjustments, particularly through a reduction in the number of civil servants in Chuuk and Kosrae. These cuts were phased over a five-year period. Following these adjustments, the FSM was tasked with preparing decrement management plans. These plans were designed to help FSM governments reduce expenditures in response to annual funding decrements and the lack of full indexation through Compact grant funds.

A major tax reform effort in the mid-2000s failed to gain traction despite significant support. In 2004, the FSM initiated a tax reform initiative with support from the ADB and the Pacific Financial Technical Assistance Center (PFTAC) to enhance revenue collection in response to reduced Compact funding. A series of laws were drafted, requiring action at both the National and State levels, and a tax advisor was brought in for a two-year period to drive the process. The required laws were passed in Chuuk and Kosrae, the two states most adversely affected by early expenditure cuts, and the FSM National Government established a Unified Revenue Authority. However, two FSM states—Pohnpei, due to an unsupportive private sector, and Yap, due to constitutional concerns—failed to support the initiative. Despite several attempts to restart the program, none have gained momentum.

While recent reforms in the FSM have faced challenges, changing circumstances suggest the time may be right to revisit the reform agenda, particularly for private sector development. The FSM's past experience with reform, following the reduction in Compact funding under both the original and the 2003 amended Compacts, has been largely

Progress with reform in the FSM has been weak. However, changed circumstances, including a favorable outlook suggest the time may be right to implement reforms that have been on the back burner for a long time.

unfavorable. During these periods, the FSM faced "reform fatigue," and the environment for reform was not conducive to success. The tax reform effort, which required the cooperation of the FSM National Government and at least three of the FSM state governments, was particularly challenging. However, the situation has changed. The 2023 amended Compact has been renegotiated on favorable terms, without the need for adverse adjustments at the state level. Although the redistribution of fishing fees negatively affects the FSM National Government, it also provides an incentive for the FSM National Government to support reform initiatives. As discussed in the previous section, economic performance in the FSM is likely to improve, but this growth is primarily driven by the public sector, which is limited by the increase in resources. For further improvement, the FSM must refocus its efforts on the reform agenda, particularly to stimulate private sector development.

Outline of a Reform Agenda

Public sector reform and PFM

1. **Tax reform**. It is well established and documented in many studies that the FSM tax regime inherited from Trust Territory days is outdated, inefficient and in need of reform. A modern tax reform structure suited to the FSM and other small island economies has been well developed by the IMF. Previous reform initiatives in the FSM were based on these recommendations and proposed institutional arrangements, with laws drafted and a framework ready for implementation. With the secure future provided by the 2023 amended Compact, the outlook is favorable for focusing on positive actions, such as enhancing revenue efforts at the national level. Additionally, with the recent successful implementation of tax reform in Palau and the adoption of reforms in the RMI, the FSM now has valuable regional experience to draw upon.
2. **PEFAs and PFM Roadmap at National and State Levels**. The FSM has completed Public Expenditure and Financial Accountability (PEFAs) assessments and developed Public Financial Management (PFM) roadmaps. Recent technical assistance (TA) has focused on PFM reform at the national level. Given the changing fiscal environment, there is a clear need for improvements in public service delivery efficiency at the national level. However, the more pressing need lies at the state level, where most services are delivered, and where no significant PFM analysis or reforms have been implemented. To address this, initial state-level PEFAs would be necessary, followed by the development of state-level PFM roadmaps. This process would require both strong commitment at the state level and substantial TA support.
3. **Public sector wage policy**. A clear set of guidelines for public sector wages is essential as part of the PFM reform effort. In the past, when resources were available, there has been a tendency to increase payroll at the expense of other operational costs. With sufficient fiscal space to maintain current payroll levels, including inflation adjustments, a well-defined wage policy can be developed. This policy could set boundaries for wage increases and hiring, particularly in key areas where priorities exist. The IMF has developed tools for conducting such analysis, which were recently applied in Palau.
4. **Fiscal Responsibility and Debt Management**. The FSM National and State governments have yet to adopt or consider a fiscal responsibility and debt management act. Both Palau and the RMI have implemented such

frameworks. During the original Compact and the 2003 amended Compact, there was little incentive for fiscal discipline at the national level due to abundant resources and large expenditures on electoral district projects. However, with resources at the National Government now more constrained, it is an appropriate time to consider establishing guiding principles for fiscal behavior. Additionally, the loss of "grant-only status" and eligibility for concessional loan financing underscores the importance of a debt management policy to set clear guidelines for new debt incurrence. As with other PFM reforms, a fiscal responsibility and debt management framework is also needed at the state level, though it should be simplified for state-level application.

5. **Strategic Development Plan**. The analysis in this Review shows that the Strategic Development Plan (SDP) provides a list of high-level objectives but lacks a framework for annual budget preparation, implementation, or monitoring. It also does not include a detailed macroeconomic framework outlining potential development paths for the FSM over the next 20 years. Developing such a framework will require significant donor support and stakeholder participation, as was the case during the drafting of the 2003 SDP. The previous effort culminated in the third FSM economic summit, which included a broad range of stakeholders from various levels of society and states. This summit, in turn, led to a high-level donor Consultative Group meeting.

6. **State-Owned Enterprises**. The SOE sector in the FSM has incurred less fiscal risk compared to its sister Micronesian states. However, several significant issues remain. Pohnpei utilities have faced legislated restrictions that prevent the adoption of an efficient pricing regime. FSM Telecom has implemented policies that duplicate infrastructure and are inconsistent with national ICT policy. PetroCorp, which took on the responsibility of supporting the struggling copra sector, has been affected by labor shortages due to large-scale out-migration. This has contributed to a decline in PetroCorp's profitability, although audits lack sufficient data to assess cross-subsidization. These challenges suggest that the FSM should consider adopting a comprehensive SOE framework that clearly defines the sector's objectives, including commercialization, community service obligations, and necessary governance reforms.

Private Sector Reforms

7. **Private Sector Assessment** It has been over 20 years since the last study of the FSM's private sector was conducted. In the absence of a defined private sector reform agenda, a logical step forward would be to request support for a Private Sector Assessment. The Private Sector Development Initiative (PSDI) in Sydney, an arm of the ADB, along with other donors, would be an ideal organization to conduct this study. The assessment should cover a broad range of topics and provide a clear framework for developing a Private Sector Development Roadmap.

8. **Foreign Direct Investment**. The Foreign Direct Investment (FDI) regime in the FSM has been notably unfavorable toward private sector investment. The existing regime was developed by the Foreign Investment Advisory Service (FIAS), which is no longer in operation but has since been absorbed by other entities. Both state and national levels hold regulatory powers over FDI. For

instance, Pohnpei State retained its legacy Foreign Investment Board, while Yap initially adopted the FIAS reforms but reverted to a similar legacy structure after a large tourism development initiative. National-level reforms and legislation aimed at regulating FDI have not come to fruition. Despite these challenges, FDI remains a key avenue for development, offering the potential to enhance economic performance beyond reliance on the public sector. However, the path forward for fostering FDI, particularly with state-level jurisdictions, is fraught with obstacles and requires clear path to reform.

9. **Fisheries and the FSM Arrangement**. The fisheries sector has revealed inefficiencies within the FSM arrangement, particularly regarding the preference for domestically flagged vessels that contribute little to the domestic economy compared to non-flagged vessels. The granting of these substantial discounts further erodes the revenue base, potentially resulting in a loss of up to $20 million, or 30 percent of the current fishing fee levels. While this Review cannot precisely quantify the loss, it strongly recommends a transparent third-party assessment to provide the FSM with evidence-based insights, enabling informed decision-making.

FSM summary economic indicators, FY23-FY27

	FY23		Population	GDP per capita
GDP current prices, $ million	438.6	Chuuk	36,282	3,149
Population (indicative GSUSA estimates)	76,692	Kosrae	4,934	5,444
GDP per capita $	5,719	Pohnpei	26,992	8,987
GNI per capita $	5,590	Yap	8,484	6,476
GNDI per capita $	7,504			
Population estimtes are indicative only.				
GDP estimates are based on proxy data for the private sector from FY16 and not official				

	FY23	FY24	FY25	FY26	FY27
National accounts					
GDP, at constant prices $ million, FY04 prices	250.7	254.9	256.8	259.6	262.6
GDP, % growth	*0.4%*	*1.6%*	*0.8%*	*1.1%*	*1.2%*
GDP, % growth (excluding purse seine fishing boats)	*1.5%*	*-0.1%*	*0.9%*	*1.1%*	*1.4%*
GDP, at current prices $ million	438.6	454.9	457.9	471.3	494.6
Official GDP series was suspended after FY16 due to lack of availability of private sector source data					
FSM by Institution, at constant prices $ million, FY04 prices					
Private Sector[1]	49.8	49.1	50.4	52.3	54.6
Public Enterprise	18.5	23.1	23.4	23.9	23.8
Financial Institutions	15.2	14.9	15.0	15.2	15.6
National Government	15.1	15.2	15.4	15.5	15.7
State Government	43.5	45.2	45.1	45.1	45.0
Municipalities	1.5	1.5	1.5	1.5	1.5
Government Agencies	10.4	10.3	10.4	10.5	10.5
NGO's and Non-Profits	3.2	3.2	3.2	3.2	3.2
Households subs	59.3	58.5	57.6	56.8	56.0
Households mixed	19.4	19.1	19.3	19.7	20.2
less intermediate FISIM	*-6.5*	*-6.4*	*-6.4*	*-6.6*	*-6.7*
GDP at basic prices	229.5	233.8	235.0	237.2	239.3
Indirect Taxes	*23.0*	*22.6*	*23.3*	*24.0*	*24.9*
less subsidies	*-1.8*	*-1.5*	*-1.5*	*-1.6*	*-1.6*
GDP FSM	250.7	254.9	256.8	259.6	262.6
1. GDP estimates for the private sector are based on proxy data and indicative only reflecting a lack of source data					
Prices (annual percent change)					
Consumer price index	6.2%	5.4%	-1.5%	0.6%	2.9%
GDP deflator	5.6%	2.0%	-0.1%	1.8%	3.7%
Employment and Wages					
Number of employees	14,718	15,232	15,671	15,997	16,299
% change	-0.5%	0.1%	-1.1%	1.0%	3.5%
Private sedctor	5,887	6,182	6,352	6,723	7,006
% change	-4.6%	-3.3%	-1.0%	5.0%	2.8%
Public sector	7,902	7,725	8,086	8,154	8,189
% change	3.0%	2.2%	-1.5%	-2.2%	4.7%
Average annual nominal wage	11,884	11,968	11,985	12,116	12,331
% change	4.0%	2.8%	1.3%	1.3%	1.5%
Private sector	7,104	6,934	6,851	6,939	7,038
% change	4.9%	-2.4%	-1.2%	1.3%	1.4%
Public sector	16,048	16,194	16,451	16,762	17,296
% change	5.6%	0.9%	1.6%	1.9%	3.2%
Average annual real wage (less inflation)	10,471	10,001	10,164	10,215	10,100
% change	4.0%	2.8%	1.3%	1.3%	1.5%

FSM summary economic indicators, FY23-FY27 cont'd

	FY23	FY24	FY25	FY26	FY27
Government Finance Statistics, $ millions					
Revenue	269.5	280.3	301.7	312.6	324.0
Tax revenue	68.6	65.3	72.5	72.9	76.5
Grants	116.9	127.2	146.1	156.8	164.7
Other revenue	83.9	87.8	83.2	82.9	82.8
Expense	-238.2	-237.9	-258.2	-266.4	-274.5
Compensation of Employees	-93.6	-106.8	-121.6	-125.8	-130.2
Use of goods and services	-122.6	-115.5	-110.8	-114.7	-118.4
Other expense	-22.0	-15.7	-25.8	-25.9	-25.9
Net Worth and its Changes	-30.0	-39.6	-43.5	-46.3	-49.5
Nonfinancial assets	-37.5	-43.5	-34.9	-43.0	-50.6
Financial assets	12.3	6.9	-4.6	0.6	5.0
Financial liabilities	-4.7	-3.0	-4.0	-3.9	-3.9
Overall fiscal balance	**-6.3**	**-1.1**	**8.6**	**3.3**	**-1.1**
In percent of GDP (excl. MRA)					
Revenue	61.4%	61.6%	65.9%	66.3%	65.5%
Taxes	15.6%	14.4%	15.8%	15.5%	15.5%
Domestic revenues	26.7%	28.0%	31.9%	33.3%	33.3%
Grants	19.1%	19.3%	18.2%	17.6%	16.7%
Expense	-54.3%	-52.3%	-56.4%	-56.5%	-55.5%
Compensation of Employees	-21.3%	-23.5%	-26.6%	-26.7%	-26.3%
Use of goods and services	-28.0%	-25.4%	-24.2%	-24.3%	-23.9%
Non Financial Assets	-8.6%	-9.6%	-7.6%	-9.1%	-10.2%
Overall fiscal balance	**-1.4%**	**-0.2%**	**1.9%**	**0.7%**	**-0.2%**
Balance of Payments $ million					
Trade balance	-200.4	-191.9	-192.9	-199.4	-211.3
Service balance	-26.5	-25.4	-32.0	-37.7	-42.8
Primary Income balance	41.0	39.4	38.9	37.7	35.9
Secondary Income balance	187.1	191.9	200.3	205.6	208.2
Current Account, balance	1.2	14.1	14.3	6.1	-10.1
Capital Account, balance	6.4	7.4	14.9	22.6	30.6
Financial account balance	-17.4	-20.3	-10.7	-4.9	-6.7
Errors and omissions	-9.9	1.3	18.5	23.8	13.8
Errors and omissions % Goods and Services	-2.1%	0.3%	3.7%	4.6%	2.5%
External Debt, $ million					
Gross External Debt Total	79.4	78.5	65.7	57.2	50.2
Gross External debt as % of GDP	18.1%	17.3%	14.4%	12.1%	10.2%
Debt Service	6.9	6.6	6.8	6.3	7.6
Debt service as % of national government revenues	3.5%	4.7%	4.8%	3.2%	5.0%
Money and Banking ($ million)					
Assets	488.0	507.0	522.6	533.8	547.4
Foreign assets	384.9	401.1	418.6	427.0	438.4
Loans	83.1	84.7	84.4	86.4	88.3
Commercial loans	48.1	48.2	46.4	47.1	47.6
Consumer loans	34.9	36.5	38.0	39.3	40.6
Other assets	20.0	21.1	19.6	20.4	20.8
Liabilities	488.0	507.0	522.6	533.8	547.4
Deposits	442.9	466.6	482.8	493.9	507.2
Demand	169.0				
Savings	254.2				
Time inc. orther deposits	19.7				
Capital	45.1	40.4	39.8	39.9	40.2
Loans to deposit ratio, %	18.8%	18.2%	17.5%	17.5%	17.4%

FSM
ECONOMIC REVIEW 2024

Federated States of Micronesia

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The FSM Economic Review is produced annually to provide an independent assessment of the Federated States of Micronesia's economic performance and policy environment, as well as independently verified economic statistics. The Review has been developed to assist the governments of the FSM and the United States to fulfill their respective reporting requirements under FSM's Compact of Free Association with the United States.

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