Federated States of Micronesia

FY2007 Economic Review

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CURRENCY EQUIVALENTS

Currency Unit	—	United States Dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
Amended Compact	—	Second phase of the Compact, FY2004–2023
BPS	—	Budget Preparatory Software
BSS	—	Basic Social Services
c.i.f.	—	Cartage, insurance and freight
CIP	—	Capital Improvement Project
Compact	—	FSM Compact of Free Association with the United States
Compact I	—	First 17 years of the Compact, FY1987–2003
CPI	—	Consumer Price Index
CTF	—	Compact Trust Fund
DEA	—	Department of Economic Affairs, FSM
DOI	—	Department of Interior, U.S. Government
EPIC	—	Economic Policy Implementation Council
ERP	—	Early Retirement Program
ESC	—	Executive Steering Committee
FDI	—	Foreign Direct Investment
FEMA	—	Federal Emergency Management Agency
FIAS	—	Foreign Investment Advisory Service
FMIS	—	Financial Management Information System
f.o.b.	—	Free on-board
FPA	—	Fiscal Procedures Agreement
GDP	—	Gross Domestic Product
GRT	—	Gross Receipts Tax
HIES	—	Household Income and Expenditure Survey
IMF	—	International Monetary Fund
MTN	—	Medium Term Notes (Compact-backed bonds)
NGO	—	Nongovernmental Organization
OCM		Office of Compact Management, FSM
OIA	—	Office of Insular Affairs,
PFTAC	—	Pacific Finance Technical Assistance Center
PIER	—	Pacific Island Economic Report
PMCB	—	Performance Management Capacity Building
PSDP	—	Private Sector Development Program
PSE	—	Public Sector Enterprise

PSRP	—	Public Sector Reform Program
SDP	—	Strategic Development Plan
SEG	—	Special Education Grant
SGS	—	Sustained Growth Strategy
TA	—	Technical Assistance
TRTF	—	Tax Reform Task Force
U.S.	—	United States
VAT	—	Value Added Tax

NOTE

The Federated State of Micronesia government's fiscal year (FY) ends on September 30.

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FOREWORD

This report has been prepared to assist the Government of the Federated States of Micronesia (FSM) and U.S. Department of Interior to fulfill their respective reporting obligations under the Compact of Free Association with the United States. In the case of the FSM, the nation is required under Title One Section 214 to report to the U.S. President on the use of sector grant assistance and progress in meeting mutually agreed program and economic goals. In the case of the United States under Title One Section 104.h the President is required to submit a similar report to Congress concerning developments in the FSM. This report has been prepared under a grant from the Department of Interior and administered through the U.S. Department of Agriculture Graduate School. However, it is not intended to directly fulfill the reporting requirements of the two governments. Rather it is intended to provide an assessment of FSM economic performance, its policy environment and, a set of economic statistics. It is envisaged that much of the material will be directly relevant for the two reports. However, the reporting requirements of the two governments are different and thus not all the material will be relevant to both reports.

The report is comprised of two parts: a descriptive section of economic developments in the FSM and discussion of policy developments, prospects, and issues. The descriptive section takes a standard macroeconomic approach and includes discussion on economic growth and employment, monetary developments and prices, the external sector, and fiscal developments. In the policy discussion the report is intended to review key topical areas rather than provide a comprehensive review. Discussion focuses on public expenditure management, private sector development, issues of economic reform, and the long-run outlook. Following the descriptive and analytical sections, a comprehensive set of economic statistics is provided.

The author would like to express thanks to the many people who have contributed and made this report possible. First, to Glenn McKinlay who assisted with the compilation of the economic time series database and in particular the national accounts. Second, to the Department of Economic of Affairs and Sancherina Salle, who supported the project and provided much important information. To Evelyn Adolph of the Department of Administration and Finance who also provided insight on the tax reform initiative.

Mark Sturton

INTRODUCTION AND SUMMARY

This review has been prepared to assist both the FSM Government and the United States in the fulfillment of their respective obligations under the Compact. In the case of the FSM the amended Compact states under Title One Section 214 that:

> *"The Government of the Federated States of Micronesia shall report annually to the President of the United States on the use of United States sector grant assistance and other assistance and progress in meeting mutually agreed program and economic goals. The Joint Economic Management Committee shall review and comment on the report and make appropriate recommendations based thereon."*

In the case of the United States the President is required to submit a similar report to the Congress concerning similar developments. Under Title One Section 104.h of the amended Compact it states:

> *(1) REPORT BY THE PRESIDENT.—Not later than the end of the first full calendar year following enactment of this resolution, and not later than December 31 of each year thereafter, the President shall report to Congress regarding the Federated States of Micronesia and the Republic of the Marshall Islands, including but not limited to—*
>
> > *(A) general social, political, and economic conditions, including estimates of economic growth, per capita income, and migration rates;*
> >
> > *(B) the use and effectiveness of United States financial, program, and technical assistance;*
> >
> > *(C) the status of economic policy reforms including but not limited to progress toward establishing self-sufficient tax rates;*
> >
> > *(D) the status of the efforts to increase investment including: the rate of infrastructure investment of U.S. financial assistance under the U.S.-FSM Compact and the U.S.-RMI Compact; non-U.S. contributions to the trust funds, and the level of private investment; and*
> >
> > *(E) recommendations on ways to increase the effectiveness of United States assistance and to meet overall economic performance objectives, including, if appropriate, recommendations to Congress to adjust the inflation rate or to adjust the contributions to the Trust Funds based on non-U.S. contributions.*

The review is presented in two parts: a review of economic developments, and a section on policy developments, prospects, and issues. While this report relates to the fiscal period FY2007, analysis of developments in that year alone would provide a limited and one-sided view. The approach has been rather to review developments in a broader context since FY1995 so that a more informed assessment can be made. The first section of the report, the review of economic developments, updates the FY2006 Compact report, but focuses and adds reference to FY2007. The content of the review of economic developments follows a standard macroeconomic approach and discussed economic growth and employment, prices, money and banking, the balance of payments, and, finally, fiscal developments.

In the second part of the review the discussion comprises three sections: (i) public expenditure management, (ii) private sector development, and (iii) Compact adjustment and the economic outlook. In the mid-1990s the nation embarked on a program of public sector reform assisted through an Asian Development Bank (ADB) program loan. This review looks at the changes made during the Public Sector Reform Program (PSRP) and whether they remain in force. In particular, trends in public sector payroll are examined.

In 2003 the FSM embarked on a Private Sector Development Program (PSDP), a loan-assisted program supported by the ADB, designed to improve the environment for private sector development. In the second section of the policy review progress in the execution of the policy components and fulfillment of the conditions of second tranche draw down are reviewed. Tax reform has been an important component of the reform agenda and although implementation has been slow, it is now finally getting underway. While greater tax effort is now too late to assist in the adjustment to the phase out of non-conforming uses of the capacity building grant, the need for tax reform to provide an adjustment mechanism to the annual decrement that supports the private sector remains important.

The third section of the policy review is concerned with the medium and long-term prospects of the FSM economy. Adjustment to the phase out of non-conforming uses of the capacity building grant in Kosrae and Chuuk states is considered. Discussion proceeds to the long-run, and compares recent performance with the “sustained growth strategy” adopted by the FSM at the Third Economic Summit. Analysis indicates that actual performances falls short even of the “dismal scenario” also outlined at the summit, and indicates the need for immediate fiscal stabilization and completion of the adjustment process to the new requirements of the amended Compact.

SPECIAL CAVEAT CONCERNING THE FY07 COMPACT REPORT

The production of the FY07 Compact report has departed from the normal procedures in the compilation of the statistics and preparation of the text of the report. In normal circumstances the statistical database, on which the report is based, is compiled after a comprehensive collection and analysis of statistical information. In the case of the FY07 report this task was undertaken remotely and in many cases the information available was incomplete and insufficient for a comprehensive analysis.

In particular the estimation of the national accounts was based on incomplete data. For the private sector the normal practice is to base the estimate on Gross Revenue Tax collections. However, in FY07 there was a change in the tax base making this procedure impossible without an in depth analysis of the dataset. Estimation of private sector developments thus had to be based on Social Security information relating to wage and salary payments. In the case of the public enterprises a review is normally undertaken of the annual audits. For FY07 estimates were based on the previous year. For the public sector the estimates are based on the five government payroll systems. However, the adoption of new financial management systems in each government has resulted in the former procedures being obsolete. Again Social Security information came to the rescue. As a result the FY07 figures contained in this report for the national accounts are incomplete and would only be considered as preliminary estimates. In addition data on the external sector is incomplete. While a table has been provided on the trade statistics only aggregate data for each state was prepared. Particularly important is the complete absence of any balance of payments estimates for FY07.

Clearly, to the extent that the dataset is incomplete the analysis based on it must be viewed with caution. Apart from the national accounts and balance of payments weaknesses, however, the remainder of the report is based on final information for FY07: employment and wage data, tourist arrivals, prices, monetary information and the fiscal accounts. While the report that has limitations it may be considered as a fair representation of the developments for FY2007.

Concerning the policy components of the report, the absence of detailed discussion in the FSM has limited analysis of topical issues. A review of public sector reform issues and adoption of new financial management systems and performance management in the allocation of public sector resources has not been possible. While a review is contained on tax reform and the fiscal adjustments in Kosrae and Chuuk, the discussion is based on information provided remotely from the FSM. Further there was no attempt to make any preliminary estimates and projections of GDP for FY08 and FY09. Thus it has not been possible to include a section on the short-run prospect of the economy. The current report should thus be considered as an interim solution to maintain the series, but that a full effort should be undertaken for FY08 if the report is to continue to provide a fair representation and assessment of economic developments in the FSM.

REVIEW OF ECONOMIC DEVELOPMENTS

Growth and Employment

ECONOMIC GROWTH

1. This section of the economic review is concerned with economic performance of the FSM in FY07; the fourth year of the amended Compact period. However, in order to explain and understand recent economic developments, it is necessary to place the developments of FY2007 in a longer-term perspective. While economic developments will be reviewed over the FY1995–FY2007 period, a brief recap of the major features of Compact I is helpful. The structure of Compact I economic assistance from FY1987–FY2003 was front-loaded with two stepdowns after 5 and 10 years entailing a 15 and 22 percent reduction in base grant funding. The transfers were only partially indexed to U.S. inflation, resulting in a real reduction in resource flows amounting to an annual average decline of 4 percent. Provision was made for a further two years of funding through FY2003, but at the average level of funding during the first 15 years. The original Compact period thus incorporated three large distinct fiscal shocks and challenges to the economy: two negative ones requiring substantial downward adjustment and a third "bump-up" in resources requiring measures to limit unsustainable increases in public expenditures.

2. Before discussion of the economic performance comment on the base year of the review period, FY1995, should be made. FY1995 was the height of economic activity during Compact I when real gross domestic product (GDP) reached a peak. From that point until the end of Compact I, and even to this day, real GDP has failed to return to its zenith. It could be argued that this period is not a suitable point for analysis. However, FY1995 is the midpoint during the 1990s, precedes the impact of the second step-down, and provides a suitably long period to review developments.

3. Economic developments since FY1995 are described in Table 1. From FY1995 until FY2007 (estimated) the economy declined by 0.2 percent, reflecting economic per-

Table 1 Average real GDP growth per annum by state and economic sector[1]

[redacted]

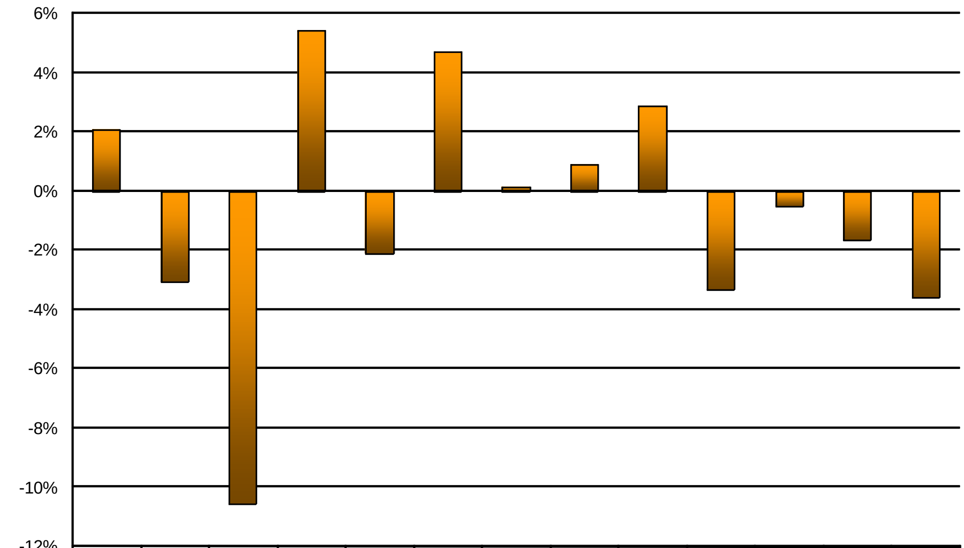
Notes 1 Growth rates computed using least squares.
2 Pohnpei inclusive of national government.

formance in each of the four states. Growth in Chuuk and Kosrae recorded an annual decline of -0.6 percent, with Pohnpei just below zero and only Yap managing to sustain a positive outcome of 0.5 percent. While growth of the public sector declined in all states, private sector activity remained positive in Chuuk and Yap, but actually declined in both Kosrae and Pohnpei. Although FY1995 represented the high point of Compact I, resulting from a rapid expansion in the public sector, the overall result since that time is extremely disappointing: GDP growth declined and the private sector contracted.

4. The period FY1995 through FY2007 can be usefully analyzed in three separate intervals: the impact of the second step-down: FY1995–1997, recovery and the final phase of Compact I: FY1997–2003, and the start of Compact II: FY2003–2007. The second step-down of Compact I in FY1997 was large in magnitude and required a painful adjustment. Supported by an ADB Public Sector Reform Program Loan, an Early Retirement Program (ERP) was initiated to reduce the number of public servants to an affordable level. By loan close-out in December 1999 the work force had been reduced by 23 percent against a target of 27 percent and the wage bill had been cut by 29 percent against a target of 35 percent through reductions in the number of hours in the working week. . While not fully meeting the targets, the program was successful in terms of fiscal adjustment and avoided a potentially destabilizing financial situation. Balance with respect to recurrent operational expenditures was restored by the end of FY1998. Not unsurprisingly, the adjustment required to restore balance after the second step-down had a significant impact on the economy. The government contribution to GDP declined by an average annual rate of 7.2 percent between FY1995 and FY1997, while total GDP fell at an annual rate of 7.1 percent. The private sector was severely affected and declined by 11.2 percent annually over the period.

5. While the second step-down in Compact funding imparted a significant downward shock on the economy in FY1997, the economy recovered some of the lost ground in the following two years through the end of FY1999 despite poor fiscal management and increasing expenditure overruns in Chuuk State. From the start of FY2000, with adjustment to the second step-down complete and the Chuuk crisis resolved, the FSM economy performed adequately through the end of the Compact I period. During FY2002 and FY2003, the economy continued to expand, benefiting from the infusion of the bump-up funds despite the requirement the United States had imposed that the FSM should set aside $30 million of the additional resources for contribution to the amended CTF. Overall during the final period of Compact I from FY1997-FY2003, the economy grew by 1.7 percent per annum, with an expansion in the public sector of 0.8 percent per annum, and an annual average private sector growth of 2.4 percent.

6. Turning now to economic developments during the amended Compact period FY2004 through FY2007, Figure 1 indicates the annual growth of the economy. It shows that after a period of growth in FY2002 and FY2003, boosted by the infusion of the bump-up funds, the economy went into recession in FY2004 as the level of Compact receipts fell to the new lower negotiated levels. This was a reduction from $84 million (the



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07 Est
Real GDP	2.1%	-3.1%	-10.6%	5.4%	-2.1%	4.7%	0.1%	0.9%	2.9%	-3.3%	-0.5%	-1.6%	-3.6%

Figure 1 Real GDP growth (percent)

Compact I level without bump-up) to $76 million. Projections in the Strategic Development Plan (SDP) had anticipated a reduction in GDP of 6 percent, but the actual outturn reveals a decline of 3.3 percent. The transition to the amended Compact thus turned out not to have been as severe as anticipated. A major component of the impact was the loss of the energy subsidy no longer available under the amended Compact in those states that had failed to operate their utilities on a cost recovery basis. In Yap the state suffered from the impact of Typhoon Sudal in April 2004, which significantly depressed output. The outturn in FY2004 further reflects a variety of Compact implementation issues which reduced the absorptive capacity to effectively utilize the available resources.

7. The inability of the FSM to establish a satisfactory mechanism for the disbursement of the infrastructure grant resulted in an almost total absence of use of this resource between FY2004 and FY2007. Absorptive capacity constraints also prevented the FSM from fully using the five operational grants. Of the total budget of $59 million in FY2004, the FSM was unable to expend $6.9 million. However, by FY2006 and in FY07 capacity constraints in the use of the five operational grants had been largely overcome. The fact that the impact on the economy of the failure to fully use the amended Compact resources was not as pronounced in FY2004 as the figures would suggest, reflects the historically low level of absorptive capacity, a level that has perhaps not been fully realized. On the positive side, the inability of the FSM to use the infrastructure grant, amounting to 30 percent of available Compact resources, represents the potential for economic expansion in the future once implementation issues have been resolved.

8. Figure 2 provides further information on recent economic developments by sector and the sustained collapse in the economy since FY2003. While the SDP had envisaged a short adjustment to the new environment of the amended Compact and return to economic growth from FY2005 onwards, the FSM economy has contracted in each year since FY2003 and GDP has fallen by 8.8 percent overall. The public sector indicates continuing decline resulting from the reduced levels of funding under the amended Compact, and phase out of the use the capacity building sector grant to fund non-conforming purposes. A very significant decline is estimated for FY07 based on reduced levels of public expenditures in Chuuk. Reflecting reduced demand from the public sector, private activity also collapsed and has fallen in each year since FY2000. Overall economic performance since the commencement of the amended Compact has been dismal, reflecting Compact implementation problems and failure of any positive response from the private sector.

STATE ECONOMIC DEVELOPMENTS

Chuuk State

9. Compounded by the reduction in Compact flows, Chuuk State suffered a severe financial crisis in the mid-1990s due to weak fiscal management (see Figure 3). Chuuk ran up large arrears with domestic and international vendors and failed to make allotments on public servant payroll. At the height of the crisis in FY1996 the state had accumulated debts of over $17 million—equivalent to 30 percent of state GDP. However, in

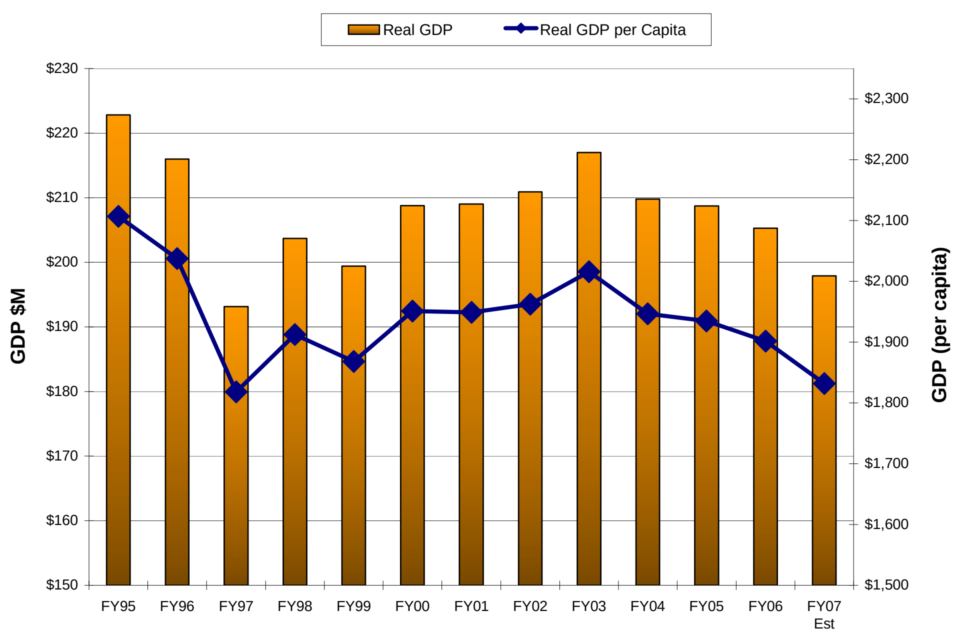


Figure 2 FSM real GDP by sector (FY1998 US$ millions)

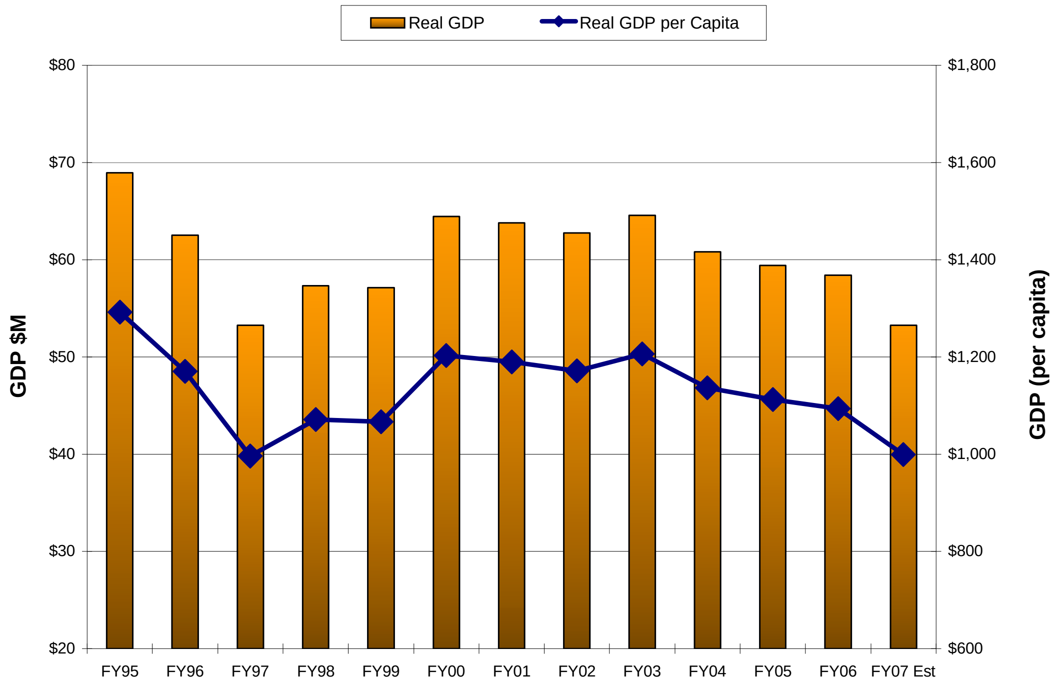


Figure 3 Chuuk State real GDP by sector (FY1998 US$ millions)

late FY1996 the state initiated a recovery program with conditioned financial support from the National Government. That program, coupled with the Early Retirement Program and reduction in the biweekly pay period to 64 hours, rapidly reversed the adverse fiscal position. By the start of FY2000 the state had repaid essentially all of its recorded arrears and was running a significant structural surplus in terms of its recurrent operations. Coupled with an airport renovation project, an increased capacity to implement development projects, and a return to a 72-hour biweekly pay period, state economic activity increased by a sizeable 13 percent in FY2000 after several years of negative growth between FY1996–FY1998. However, the level of economic activity had still to attain that achieved in FY1995.

10. The return to fiscal discipline in Chuuk lasted only four years. The elections in March 2001, revenue overestimation based, return to an 80-hour pay period in FY2001, uncontrolled off-island medical referrals, and a significant increase in hiring of contract workers led to a rapid deterioration in the state's fiscal position. During FY2002 the state returned to paying employees' net pay only, essentially defaulting on approximately 60 percent of employee deductions to vendors, banks, the FSM tax authority, and the Social Security Administration. As the crisis broke, it was estimated that the state had again run up arrears to the sum of $9 million compounded by as much as $6 million owed to complete land purchase agreements entered into without adequate authorization and appropriation. As a consequence of these developments the state economy failed to sustain the

recovery initiated in FY2000. State GDP declined by 1.1 percent in FY2001 and 1.6 percent in FY2002, despite the infusion of the bump-up funds. In FY2003, expenditures were reigned in to meet commitments to set aside the state's share of the bump-up funds. However, the expansionary impact of individual family grants from the Federal Emergency Management Agency (FEMA) to compensate households for the destruction caused by Typhoon Chata'an stimulated economic activity and the state GDP grew by 2.9 percent.

11. In FY2004 the Chuuk economy fell by a substantial 5.8 percent, reflecting a variety of factors. First, the state had to adjust to the reduction in funding after the bump-up" funds ran out in FY2003. Implementation of the amended Compact and lower levels of funding reduced government activity to more normal levels. Second, FY2003 had been an unusual year, resulting from the stimulus to economic activity from Typhoon Chata'an. In FY2004 the state did not benefit from the additional resources and economic activity again declined. Third, the amended Compact entailed a loss of the energy grant, which resulted in reduced public enterprise value added. And finally, the state continued to suffer from the financial crisis and delays in vendor payments adversely affected private sector profitability.

12. FY2005 saw continued reductions in both private and public sector activity and GDP fell by 2.3 percent. Utility prices were raised from ¢16 to ¢24 to restore profitability after the loss of the energy grant but the sector continued to be plagued by inefficiencies and power outages. Coupled with increasing food prices and the impact of the worldwide increase in fuel prices, the state Consumer Price Index (CPI) rose by 3.3 percent. In FY2006 under a new administration, the state payroll expanded by 20 percent and the biweekly wage cost rose by 14 percent. With continued pressure on the utility corporation from increasing world energy costs, electricity prices stood at ¢32 at the end of the fiscal year. Overall the state CPI rose by 5.5 percent. With an unsustainable expansion in public expenditures, fiscal stability came under severe pressure, and arrears mounted. The FY2007 budget entailed a return to the size of government payroll existing in FY2005, and electricity prices were again increased by ¢4 to ¢36. While the State was required to phase out the use of non-conforming activities from the capacity building grant, these measures were inadequate to resolve the crisis. In FY2007 state GDP is estimated to have fallen by 8.8 percent, and the state government was reputed to have debts amounting to over $40 million and to be insolvent.

Kosrae

13. Of all the FSM states, Kosrae is the one most dependent on public sector activity; it has failed to generate an active private sector. While the state achieved the ERP targets in the PSRP set for personnel, the gains have been largely eroded through increases in wages, which are now above their pre-reform levels. As a result, recurrent expenditures have returned to their former levels. In FY2002 Kosrae opted to draw down the state's share of the bump-up funds for public expenditures, and the biweekly payroll was increased from 56 to the former level of 64 hours. However, in FY2003 the state made pro-

vision to set aside an amount greater than the one-year level of the bump-up funds to contribute to the amended Compact Trust Fund. As a consequence of the additional expenditures in FY2002 the economy expanded by 4.9 percent, but state GDP fell by 2.4 percent in FY2003 (see Figure 4).

14. The first year of the amended Compact had a significant negative impact on the state economy, which experienced a large drop in GDP of 4.6 percent, as public expenditures fell back from their prior bump-up levels to the reduced amounts of the amended Compact. The outturn was similar to that of Chuuk, but with reduced impact. The loss of the energy grant also affected public enterprise profitability with adverse consequences for GDP. Between the end of 2004 and end of 2007 utility prices were nearly trebled to compensate for the loss in the energy grant and to restore viability in the sector, but at the current price of ¢20 a unit remained well below cost. FY2005 saw a large increase in inflation of 8.6 percent in the state, in part due to the increase in the utility prices, but also due to a substantial increase in food prices, the impact of the worldwide increase in fuel prices, and a general increase in prices. Since the CPI is used as the GDP deflator the increase in CPI had a significant impact and real GDP fell by 6.0 percent. In FY2006 and FY2007 these trends continued and GDP fell by 3.3 and 0.3 percent, respectively. However, the failure of the state to adjust the level of public expenditures down from the bump-up period in FY2002-FY2003 had resulted in an unsustainable fiscal position. With the need to phase out the use of the capacity building sector grant from non-conforming

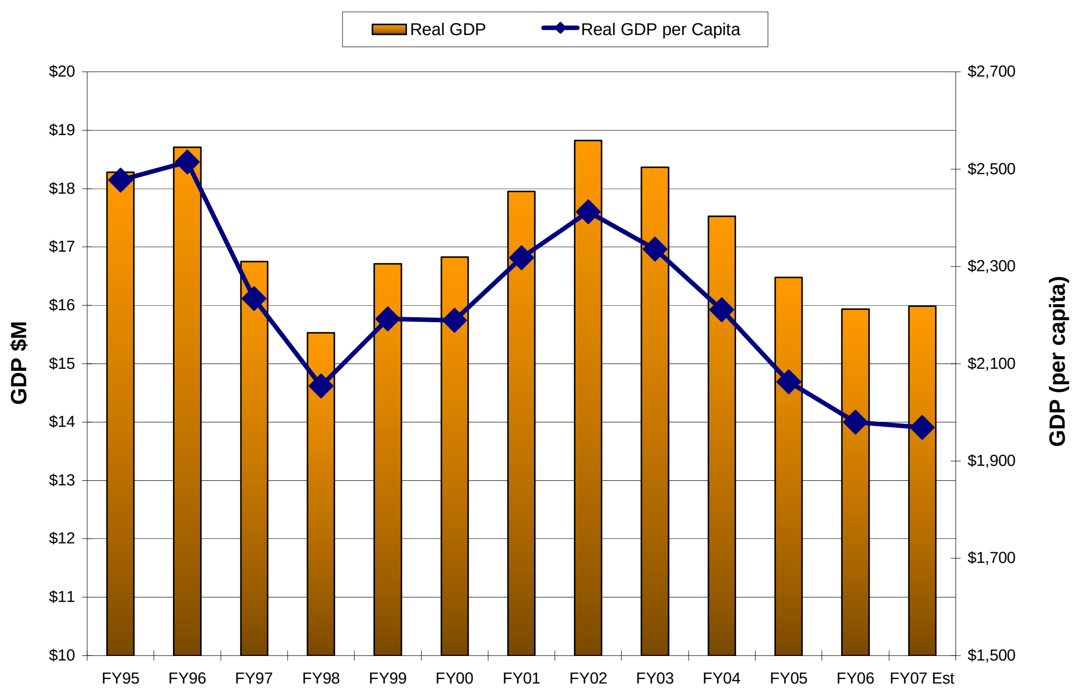


Figure 4 Kosrae State real GDP by Sector (FY1998 US$ millions)

uses, which in Kosrae's case had been back loaded to FY2008 and FY2009, the state was confronting imminent collapse in the run up to the FY2008 budget. However, in a leadership conference mid 2007 the state decided to remedy the deteriorating fiscal position through the implementation of an adjustment program, cutting expenditures and raising revenues. As a result the fiscal position improved in FY2007 and the state was prepared at the start of the new fiscal year FY2008 to confront the problem with a remedial course of action.

Pohnpei

15. Pohnpei state experienced a substantial reduction in economic activity during the second step-down, and state GDP declined by an annual average of 6.8 percent during FY1995–FY1997 (see Figure 5). From FY1997 through FY2001 economic activity stagnated and GDP rose by 1.1 percent over the four-year period. While the public sector continued to contract, the private sector was able to hold its ground, but not sufficiently to stimulate sustained economic growth. An inward-oriented policy environment and high levels of investment in unprofitable public enterprises contributed to economic stagnation. However, the state maintained a tight grip on fiscal policy subsequent to the reforms initiated in FY1996.

16. In FY2002 economic growth was strong and state GDP grew by 5.1 percent as the state fully utilized the available bump-up funds and benefited from an additional increase

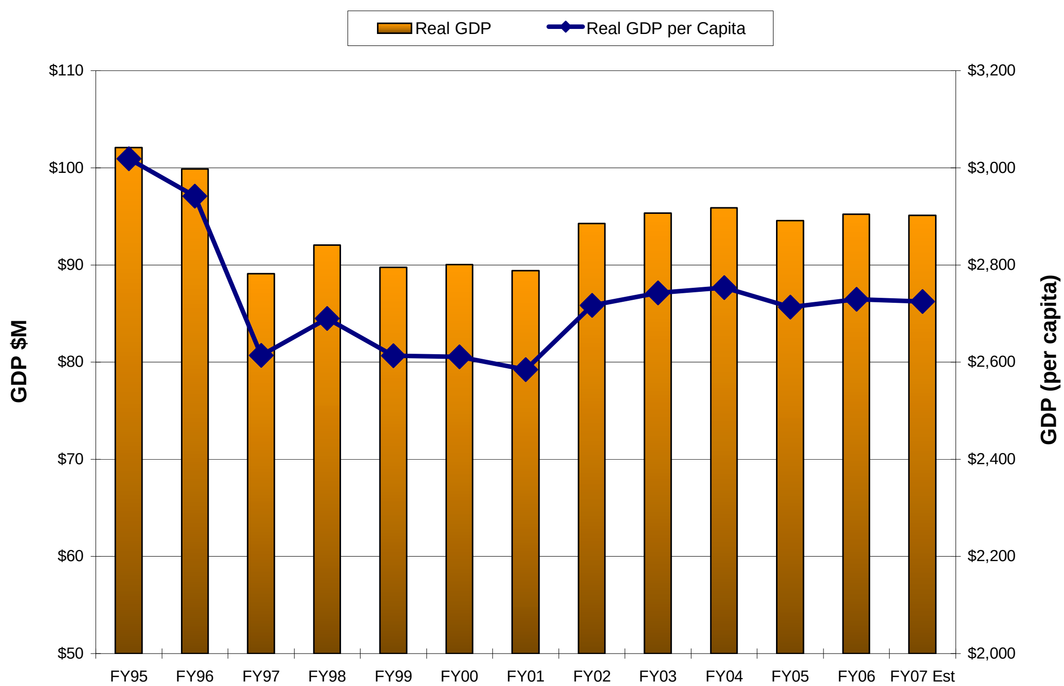


Figure 5 Pohnpei State real GDP by sector (FY1998 US$ millions)

in resources after the final repayment of the Medium Term Notes (MTN) in FY2001. (The state issued a series of MTNs, or Compact-backed bonds, in the early 1990s to fund investment in public enterprises.) In the final year of Compact I, FY2003, economic forces were mixed. The state legislature opted to fully fund a return to an 80-hour pay period so as to stimulate economic activity, but also committed to fully meeting its contribution to the Compact Trust Fund in only one year rather than setting aside the additional bump-up funds over two years. This sterilized and offset the impact of the return to the 80 hours and the economy recorded a slight increase of 0.9 percent in FY2003.

17. Perhaps surprisingly, the Pohnpei economy weathered the implementation of the first year of the amended Compact without any undue adverse impact, and GDP grew by 0.4 percent. Unlike Chuuk and Kosrae, Pohnpei State had transitioned the use of the energy grant from subsiding utility prices in the mid 1990s and thus avoided the associated reduction in public enterprise valued added. However, a 35 percent increase in tariffs to ¢31 per unit was required in FY2005 with further increases to ¢36 in FY2007 to compensate for the increase in world fuel prices. Pohnpei state hosts the national government, which was largely unaffected by the decline in Compact resources. The more developed nature of the state economy and higher revenue effort implied the state was able to make the adjustment to the new Compact regime without suffering the negative impact of the transition to a sector grant approach.

18. In FY2005, the economy managed to hold its own in nominal prices with expansion in the private sector due to increased building and construction projects, and in government services. However, as in both Chuuk and Kosrae, Pohnpei suffered from a significant boost in inflation of 4.8 percent, reflecting increases in food prices, the impact of worldwide increases in fuel prices, and a general increase in prices. The substantial increase in CPI negated the nominal expansion in GDP and, overall, the real economy contracted by 1.5 percent. In FY2006 the state economy is estimated to have grown by 0.6 percent and in FY2007 to have contracted by -0.2 percent. The public sector (both the state and national governments) continued to contract in real terms, but was offset by rising private sector activity. The source of the private sector growth has not been identified and requires additional investigation. Unlike, her sister states in Chuuk and Kosrae, Pohnpei has not funded general government from the capacity building sector grant and is thus not confronted with the same fiscal crunch and a more favorable outlook might be expected.

Yap

19. The Yap state economy achieved the highest rate of economic growth of all FSM states during Compact I although not without significant volatility. While the state underwent a public sector contraction similar to the other states after the second step-down, the private sector managed to remain buoyant and assisted the state in maintaining positive GDP growth during FY1995–FY1997 and through the end of Compact I. While it is difficult to attribute the success of the state to any one particular factor, it has maintained stable fiscal policies, and perhaps a more laissez-faire policy environment. The state

achieved the best outcome in the PSRP, meeting its ERP targets and achieving the cost-savings anticipated. These policies were maintained through the end of the original Compact period, and the state avoided the temptation to utilize the bump-up funds to temporarily inflate public expenditures. Since that time, however, there has been some expansion in the fiscal policy stance and the state has avoided the need to phase out funding general government operations through use of investment earnings. A main weakness in the state's performance has been a lack of transformation of the loss-making public enterprise sector.

20. Figure 6 summarizes economic performance since FY1995. Subsequent to the adjustment to the second step-down the public sector continued to contract through FY2001. Yap pursued a very conservative fiscal stance during this period, largely underspending the available resources during Compact I and accumulating the savings in substantial reserves. While these policies have served the state well, the rules of the amended Compact do not permit savings of unspent resources. In FY2004 the lack of absorptive capacity resulted in the state only spending $6 million of the available $10 million. In FY2005, however, the state improved its performance utilizing over 90 percent of available funding.

21. The advent of the amended Compact saw a significant reduction in the state economy of 6.4 percent in FY2004. The reduction was largely due to the impact of Typhoon Surdal rather than any negative adjustment to the new regime. While government value

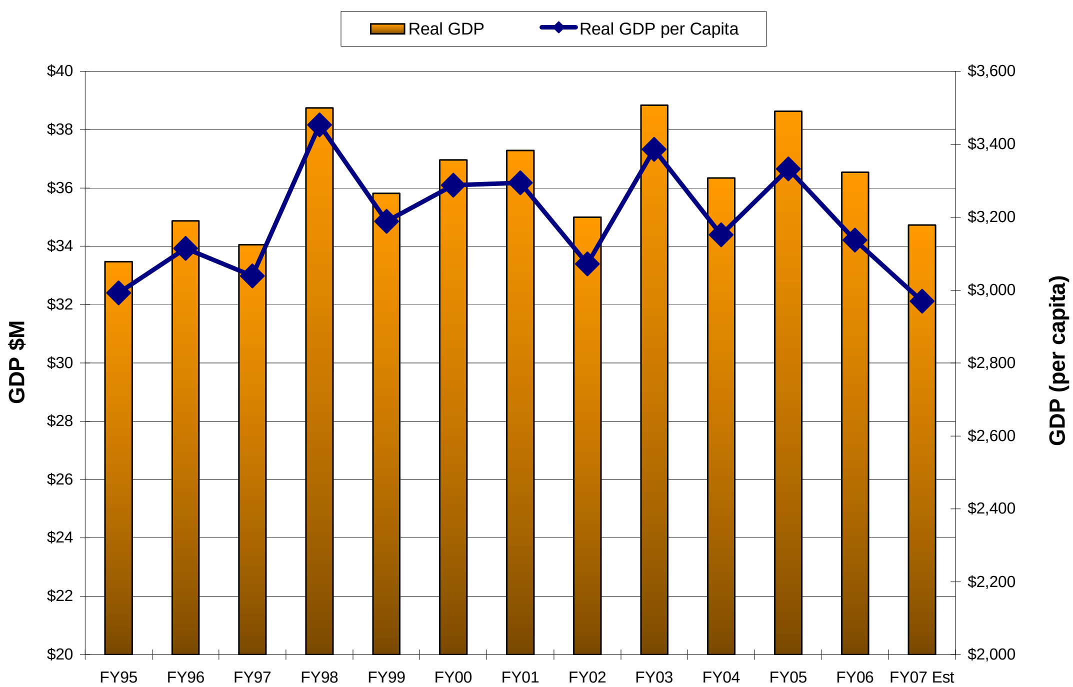


Figure 6 Yap State real GDP by sector (FY1998 US$ millions)

added actually expanded by 0.7 percent and the private sector contracted by -0.9 percent, subsistence production for own consumption fell significantly. Yap, like Pohnpei state, had also transitioned out the use of the energy grant to subsidize utility prices. However, the state continues to maintain a sizeable array of public enterprises, and in FY2004 reduced profitability in the fishing sector contributed significantly to the reduction in GDP.

22. In FY2005 the economy rebounded by 6.3 percent fueled by the infusion of FEMA funds to support rehabilitation and reconstruction. Despite significant additional demand for private sector services and the construction of the Southern Road system, closure of the two garment factories resulted in an 8.9 contraction in private sector activity. Additional funds from FEMA enabled the public sector to grow by 14.1 percent, and increased profitability in utilities due to a hike in water charges enabled the public enterprise sector to record a real growth of 14.3 percent. As in the other states, inflation also picked up in Yap and recorded an increase in the CPI of 3.3 percent due to higher food prices, world fuel prices, and a general increases in prices.

23. Although the use of FEMA funds continued to stimulate the economy in FY2006 economic activity fell by 5.4 percent reflecting the sizeable increase of 5.0 percent in the rate of inflation and substantial reduction in operating surplus of the state owned fishing enterprise. The state economy is estimated to have fallen by 5.0 percent in FY2007 and inflation fell to 4.4 percent. While the private sector saw a modest decline there were continuing substantial reductions in both government and public enterprise GDP. Like Chuuk and Kosrae, Yap initially funded a significant proportion of general government from the capacity building sector grant. However, in FY2006 the state decided to draw on its substantial investments to fund these activities. Whether the use of Yap state's carefully accumulated resources to fund public sector operations is sustainable in the long-term requires investigation.

THE STRUCTURE OF THE ECONOMY

24. The structure of the FSM economy is dominated by a large public sector with a dependent private sector producing non-traded goods that provide services to the government and its employees. While the lack of disaggregated national accounts statistics by industry inhibits a review of structural change in the economy, the data series does permit an analysis by institutional sector (See Figure 7 for changes between 1987 and 2007.) The share of the private sector expanded by 3.1 percent during the first half of the period as the Compact supported the development of a modern cash economy. However, since that period the share of the private sector has declined by 0.2 percent. This is a disappointing result and indicates loss in momentum in the attainment of the Compact objective of self-reliance. In part the failure to expand the role of the private sector reflects the adjustment to the new regime and regulations of the amended Compact. However, it also indicates a failure to implement the reform agenda adopted at the third FSM economic summit and development of a public sector and policy environment that supports private initiative.

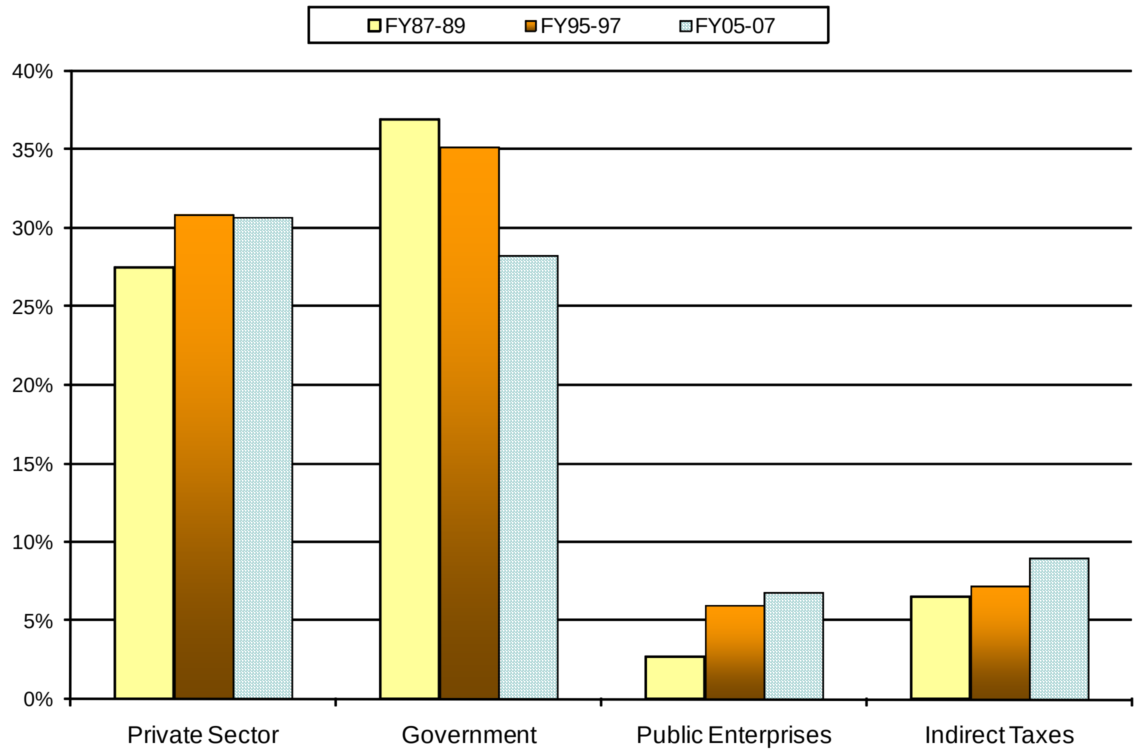


Figure 7 The institutional structure of the FSM Economy (percent)

25. While sustained improvement of the share of the private sector has not been achieved, the government sector declined significantly throughout, and its share fell by 1.7 and 6.9 percent, respectively between the three periods. The decline in government reflects two major forces: a reduction in the size of government due to the lower levels of Compact assistance especially the impact of the second step-down, and the restructuring of the public sector through the creation of Public Sector Enterprises (PSE). In part, the decline reflects the creation of PSEs to provide the utility services of power and telecommunications, which had formally been government departments. However, not all of the 3.3 percent increase in the share of PSEs in the early period was in the creation of public utilities; a significant portion of the growth was in the creation of fishing enterprises, a largely misdirected and costly venture into an area for which the public sector is wholly unsuited. While it had been anticipated that the creation of PSEs had run its course, the sector has apparently increased in significance, increasing its share by a further 0.8 percent since the mid-1990s. Overall, combining government and the PSEs, the contribution of the public sector at large has fallen by 4.5 percent since the beginning of the Compact.

26. In addition to the private and public sectors, households and indirect taxes form a significant proportion of economic activity. The household sector represents the production of non-marked goods and home ownership. The share of households declined during the early period as is to be expected in a growing economy, but has subsequently grown

in importance suggesting greater production for own consumption. While subsistence production is not directly measured, the result is highly plausible and consistent with the lack of economic growth during the last 10 years. The share of indirect taxes increased throughout the Compact from 6.5 percent of GDP during the FY1987-FY1989 period to 9.0 percent during the last three years. This development reflects two trends. First, reform of the national customs tax regime under the PSRP broadened the tax base, through subjecting all sectors in the economy to the same tax rates, and changed the basis of evaluation of duties from an f.o.b. to c.i.f. basis. Second, indirect tax rates at the state and national levels rose through the period to offset declining Compact revenues.

Sectoral Developments

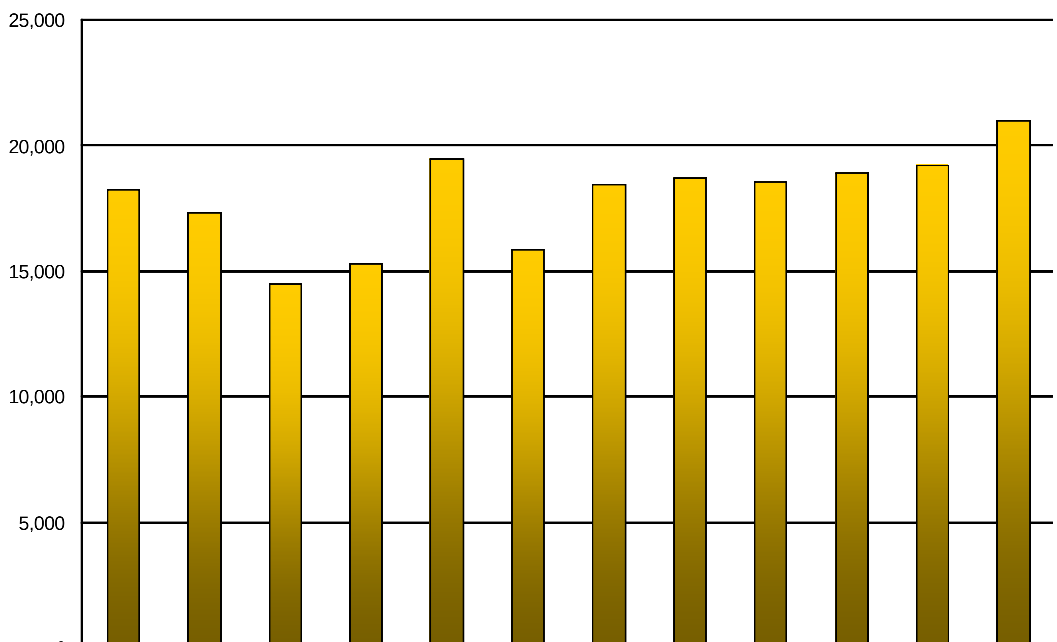
27. Data on the primary economic sectors of the FSM are weak: there are no indicators on agricultural production, limited information on agricultural exports, and fisheries information is poor. In agriculture subsistence activities make a substantial contribution to GDP, while production for either the domestic or export market is surprisingly small. The perception persists among local growers that returns from agriculture are low and slow to materialize compared with other activities such as fishing, tourism, non-traded services, and government employment. Compact assistance has exerted upward pressure on wages, turning the terms of trade against agriculture, and making agricultural production unattractive. Copra production, as in many other Pacific Island nations, has all but disappeared due to inefficiencies and low prices, but profitable export opportunities exist in other niche agricultural products.

28. With the vast marine resource falling under FSM jurisdiction it might be anticipated that fisheries would be a well-developed sector making a significant contribution to GDP. However, the sector has failed to achieve the growth anticipated. In the early 1990s, in an attempt to develop the economy, the FSM embarked on a strategy of substantial public sector investment in fisheries facilities and enterprises. Joint ventures with foreign partners in purse seine fishing operations were initiated in Chuuk, while similar but direct public sector investment in Pohnpei and Yap was undertaken. Investment in freezing, storage, and transshipment plants was undertaken in all four states, coupled with air shipment of sashimi-grade tuna to Japan by the national government. A long-line fishing company, the Micronesian Long-line Fishing Corporation, was set up with ADB loan finance for eventual sale to the private sector, but has subsequently filed for bankruptcy and liquidation.

29. However, none of the fisheries enterprises remaining in the public sector has achieved profitability. In most cases the operations are either defunct or operating with continuing losses. While there is awareness that the public sector should not be involved in the productive sectors of the economy, only recently have two public sector enterprise in the fisheries sector has been transformed. The national government divested its ownership shares in the Caroline Fisheries Corporation, and 60 percent of the enterprise is now owned by a private foreign investor. The Pohnpei Fisheries Corporation has also been leased to a private foreign investor although the assets remain under public ownership.

Divestment and establishment of an improved enabling environment, which is a key component of the Private Sector Development Program (PSDP), will help in development of the sector. It has yet to be proved, however, with the many existing structural impediments and high cost factors, whether the FSM has a long-term comparative advantage in fishing. The main benefit of the resource has been the annual rents earned from fishing access fees that make a substantial contribution to national government revenues. From the high levels received during FY1994–FY1996, when fishing royalties averaged $21 million per annum, receipts have fallen to an averaged $13.4 million during FY2004–FY2007.

30. Figure 8 indicates recent trends in the FSM tourism industry (see Tables 2 in the statistical appendix for detail on visitor arrivals for the FSM and by state.) As with neighboring tourist destination economies the Asian crisis had a significant negative impact on FSM tourism. From a level of 18,305 arrivals in FY1996 visitor arrivals slumped in FY1998 to 14,526, reflecting a downturn in Japanese and Asian tourists. The tourism industry began a slow recovery in the subsequent years, and after a boom year in FY2000, has subsequently achieved an average annual growth rate of 4 percent attaining 21,015 visitor arrivals in FY2007. Surprisingly, the events of September 11 did not adversely affect FSM tourism and numbers actually increased in FY2002. While the performance of the sector has been lackluster, it is well below the potential for an industry designated as one if not the major growth sector of the FSM economy.



	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Visitor Arrivals	18,305	17,359	14,526	15,367	19,497	15,884	18,480	18,762	18,581	18,954	19,276	21,015

Figure 8 Visitor arrivals to the FSM, FY1996–FY2006, ‘000s

31. A variety of factors currently hinder development of a vibrant tourism visitor industry. The Private Sector Development Program (PSD) initiated with ADB loan finance was intended to rectify many of the weaknesses. The climate for foreign direct investment was streamlined during the Public Sector Reform Program (PSRP) and additional improvements were carried out during the PSD. However, further reform remains to be completed before an attractive climate for private sector investment is established. The recent changes to the Pohnpei state foreign investment law to reserve investment in tourism for Pohnpeians will inevitability negatively impact tourism development. Difficulties in obtaining secure long-term land leases are also an impediment. Hotels currently operate at low capacity levels, but many of the facilities offer a standard of accommodation that is unattractive to international travelers. Reliance on a single carrier operating high-priced flights in a remote geographical location has repressed growth in demand. While these factors have all impeded tourist development, the FSM has much potential particularly as a niche market in the eco-tourism and dive areas.

INCOMES, DISTRIBUTION, AND POVERTY

32. While economic growth during Compact I was lackluster most of the gains were eroded by population growth. At the beginning of the Compact population growth as recorded between the 1986 census and 1989 was at the rapid rate of 3.0 percent per annum. Between 1989 and the next count in 1994 the rate fell to 1.9, reflecting lower fertility rates and modest rates of emigration. However, between 1994 and the most recent census in 2000, population growth fell to the low growth rate of 0.2 percent (see Table 2). While fertility rates fell, the majority of the decline reflected outward migration to neighboring U.S. territories, Hawaii, and the U.S mainland under the migration provisions of the Compact. Clearly, the negative rates of economic growth experienced in the FSM after the second step-down resulted in large-scale migration to seek employment opportunities and better rates of remuneration in the U.S. In the long-run migration plays an equilibrating role: as incomes decline outward migration compensates, improving average income levels for those remaining. Outward migration will have a distorting impact on the local economy, however, if it is achieved through a loss of the economically active and skilled. The loss of human capital will reduce the long-run productive potential of the economy.

Table 2 Population by state and annual average growth rates

	Population numbers				Annual average growth		
	1980	1989	1994	2000	1980-89	1989-94	1994-00
Chuuk	37,488	47,871	53,319	53,595	2.7%	2.2%	0.1%
Kosrae	5,491	6,835	7,317	7,686	2.4%	1.4%	0.8%
Pohnpei	22,080	30,669	33,692	34,486	3.7%	1.9%	0.4%
Yap	8,100	10,365	11,178	11,241	2.7%	1.5%	0.1%
FSM	73,159	95,740	105,506	107,008	3.0%	1.9%	0.2%

Source National Census Report May 2002

33. The relatoinship between real incomes and migration is further illustrated by FSM state in Figure 9. In all states now including Yap real incomes are indicated to have fallen, reflecting poor economic performance during the last 12 years. As a result of the decline in incomes, outmigration as measured by net movements of air passengers leaving the FSM during 2001-07 has also been large. Clearly, there is a strong association between economic performance and outmigration. Table 3 indicates the relative level of GDP per capita in each state and compares the levels in FY1995 to that of FY2007. While some of the differences in GDP per capita between states reflect the structure of the Compact and that the smaller states receive a larger per capita share, the relative levels also reflect differential rates of economic performance. To illustrate the point, in FY1995 per capita income in Yap was more than double that of Chuuk, but similar to that of Pohnpei. However, in FY2007, per capita income in Yap was nearly three times that of the level of Chuuk, 53 percent greater than that of Kosrae, and exceeded that in Pohnpei.

34. Generally speaking poverty has not been recognized as a major problem facing the FSM economy. However, a recent ADB assessment of hardship and poverty in the FSM (*The Federated States of Micronesia: Hardship and Poverty Status Discussion Paper*, The Pacific Department ADB, 2004) suggests that significant hardship exists. The discussion paper based on the 1998 Household Income and Expenditure Survey (HIES) indicates that approximately 28 percent of households reported incomes below the estimated basic needs poverty line of US$768 per capita per annum (US$5,693 per household per annum). The highest level of hardship and income poverty is 33 percent re-

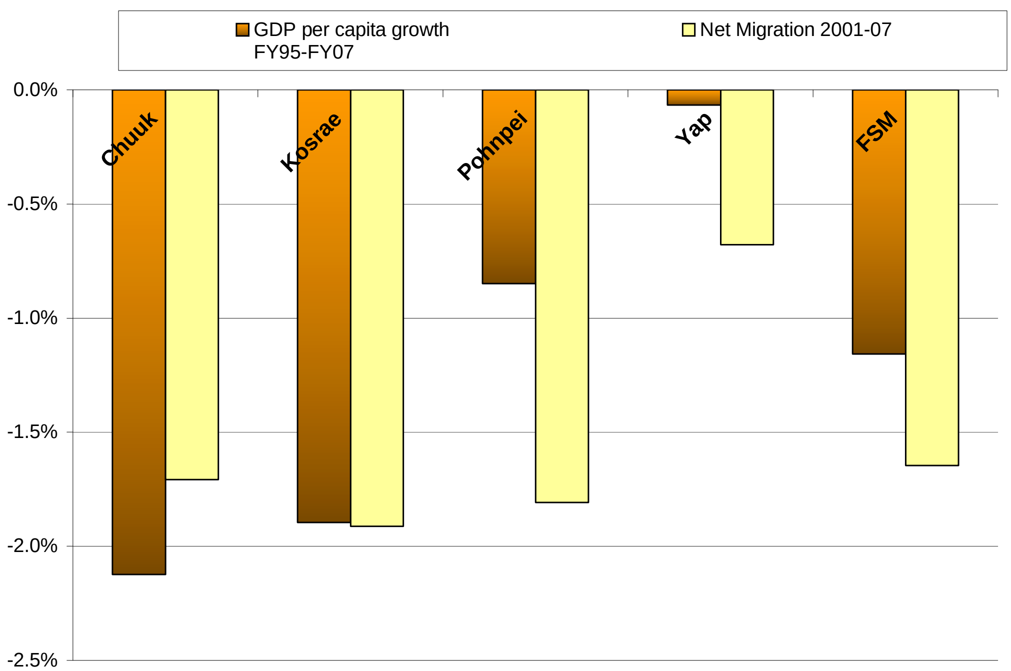


Figure 9 GDP per capita, migration, and population growth (annual averages)

Table 3 Real GDP per capita (US$ 1998 constant prices)

[redacted]

corded in Chuuk, and 30 percent in Pohnpei, while Yap and Kosrae recorded 14 and 12 percent, respectively. Households with incomes (cash and non-cash own production) below this level would be likely to experience some degree of financial hardship on a daily or weekly basis. For the 16 percent of households in Chuuk and 11 percent in Pohnpei that reported per capita annual incomes below the food poverty line of US$437 per capita per annum, the extent of hardship being experienced would be quite acute. In Yap only 3 percent of households fell below the food poverty line while none were recorded in Kosrae.

35. Analysis of the HIES also indicates that the twenty percent (quintile) of households with the lowest incomes receive only 4 percent of total income. In comparison, the highest quintile received 60 percent of income, a ratio of 15:1. These figures, together with the corresponding Gini coefficient of income inequality, 0.51, suggest that income distribution in FSM is more unequal than in many other countries of the region. The foregoing statistics were based on the 1998 HIES, which was known to have been weakly administered in the outer islands where incomes are lowest. The recently completed HIES in FY2005 will significantly help improve understanding of this important issue once the figures are released.

Employment

36. Table 4 indicates that over the period FY1995–FY2007, formal sector employment based on Social Security Administration data contracted by an annual average rate of 0.6 or 7 percent over the whole period, and was unable to provide enough jobs for new job seekers. Over the period some 1,600 jobs were lost in Chuuk with the other states showing modest gains or a marginal decrease in the case of Yap. Public sector employment contracted overall and in all states except Pohnpei as to be anticipated with the downsizing of the public sector. Private sector employment generation was positive in all states with the exception of Chuuk with significant growth in Kosrae, albeit from a low base. The general results are very disappointing and the lack of job creation clearly rein-

Table 4 Employment Growth Rates by Sector and State (annual averages)

[redacted]

Source FSM Social Security Administration Data

forces the strong incentive to migrate arising from falling real income levels, and to seek employment opportunities in the United States.

37. Figure 10 indicates recent trends in private and public sector employment since FY1995. Employment in the public sector contracted severely after the second step-down in Compact funding, reflecting a major fiscal adjustment. The ADB-financed PSRP enabled implementation of an ERP that facilitated the needed compression to restore fiscal balance. By FY2000 employment in the public sector had fallen from approximately 8,800 in 1995 to 7,600, a 14 percent reduction. However, in the following period up to FY2007 public sector employment has shown an oscillating trend reflecting the fiscal stance adopted in Chuuk state. A lack of discipline in Chuuk in FY2002 and FY2006 is reflected in peaks in total FSM public sector employment levels. However, with the impact of the need to compress expenditures with the phase out of the use of the capacity building grant to fund government operations in both Chuuk and Kosrae, public employment is projected to have fallen to a level in FY2007 just 3 percent above the level achieved at the height of public sector reforms in FY2000.

38. Private sector employment contracted between FY1995 and FY1997 reflecting the contraction in the economy, but rose again between FY1997 and FY2000 with the gradual improvement in the economy after adjustment to the second step-down was completed and the earlier financial crisis in Chuuk had been resolved. Since that time, however, and from FY2000 onwards, private sector employment has stagnated and declined by 1 percent.

Wages

39. The labor market in the FSM is relatively free from regulatory distortions and institutional rigidities. Pohnpei is the only state to impose a minimum hourly wage for the private sector; that is set at $1.35. While this wage may leave unaffected the demand for skilled workers, it may be an active constraint in labor-intensive activities, although private sector operators are not vocal. All the FSM governments have set minimum hourly wages for government employment ($2.00 for Pohnpei, $1.25 for Chuuk; $1.35 for Kos-

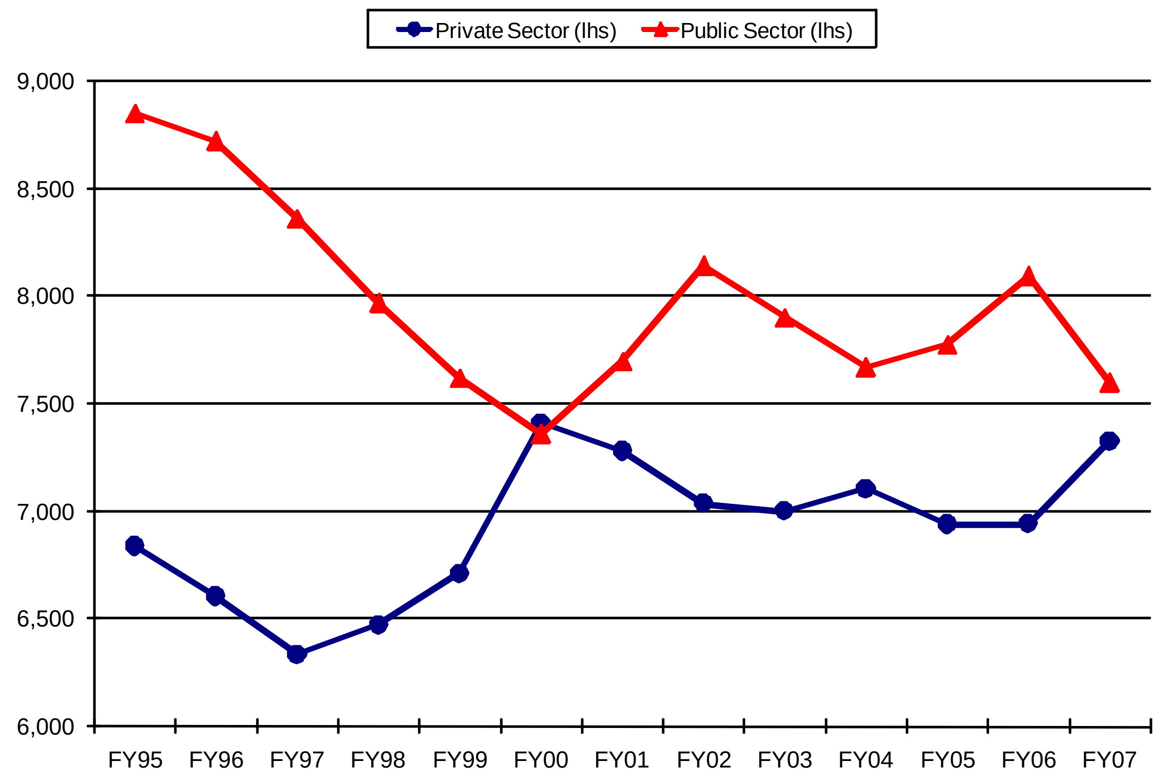


Figure 10 Employment by sector, FY1995–FY2007

rae; and $0.80 for Yap), but these levels coincide with the lowest step on the public servant pay scale and are thus redundant. There are currently no unions in the FSM and there is no indexation of wage rates.

40. However, while the labor market is relatively free from market rigidities, it is distorted by high public sector wage rates, the ease of migration and higher comparative wages in Guam and other U.S. labor markets, and the opportunity cost of labor in the subsistence sector. Table 5 indicates the level of real wages by state and between the private and government sectors. For the FSM as a whole, government wages were 78 percent higher in the FY2005-FY2007 period than those of the private sector. While the skill mix of the two activities affects the differential, the public sector clearly asserts an upward pressure on wages and influences the allocation of labor between the sectors.

41. Unfortunately, policy is constrained in its ability to influence distortions in the labor market. The effect of unrestricted external migration is part of the basic rights of FSM citizens under Title III of the Compact. However, during the Second FSM Economic Summit the FSM adopted a policy to reduce the differential between the private and public sectors. Data in Table 5 indicate that this policy objective has been achieved in Pohnpei and Yap, but in Chuuk and Kosrae there has been a significant increase in the disparity. Table 5 also indicates that real wages fell significantly in the FSM during the period FY1995–FY2007, by a total of 15 percent in the public sector, and 8 percent in the

Table 5 Real wages and differentials by sector and state

[redacted]

Source FSM Social Security Administration Data
Notes * includes national government

private sector. The most notable exceptions to these outcomes were in Chuuk and Kosrae, where real public sector wages rose by 1 percent in Chuuk and private sector wages fell by a substantial 20 percent in Kosrae.

Monetary Developments and Prices

PRICES

42. The FSM commenced price collection and established a Consumer Price Index (CPI) for each state and the nation from 1999 onwards. Tables 5a-g in the Statistical Appendix provide CPI data for the FSM and each state. A general deflator based on the U.S. CPI through 1998, but chained to the FSM thereafter, has been used in the various statistical series, including the real GDP included in this review. While the use of the chained CPI index has proved satisfactory through most of the period, recent large increases in inflation, due to increases in food prices, discretionary tax changes, and fuel prices raise the question as to whether it is the most appropriate deflator. For example, inflation in the CPI recorded 8.1 percent in Kosrae during FY2005. While deflation of nominal GDP by the CPI certainly provides an appropriate indicator of changes in real incomes, it probably overstates the reduction in real production levels. Future efforts to improve the GDP series need to establish a more appropriate deflator, but in the meantime analysis needs to recognize the deficiencies.

43. Figure 11 provides information on the rate of annual change (quarter on the same quarter of the previous year) in the FSM CPI. To narrow the focus this analysis will pick up the story from FY2003 onwards. From the first quarter of FY2003 inflation started to rise. There are four general causes of the acceleration in inflation: (1) a period of increasing imported inflation in food prices, (2) discretionary increases in import taxes levied by the national government on beer and tobacco, (3) increases in utility tariffs in Kosrae and Chuuk to compensate for the loss of the Compact I energy grant, and (4) the general worldwide increase in energy prices. In most states prices of imported food, cereals,

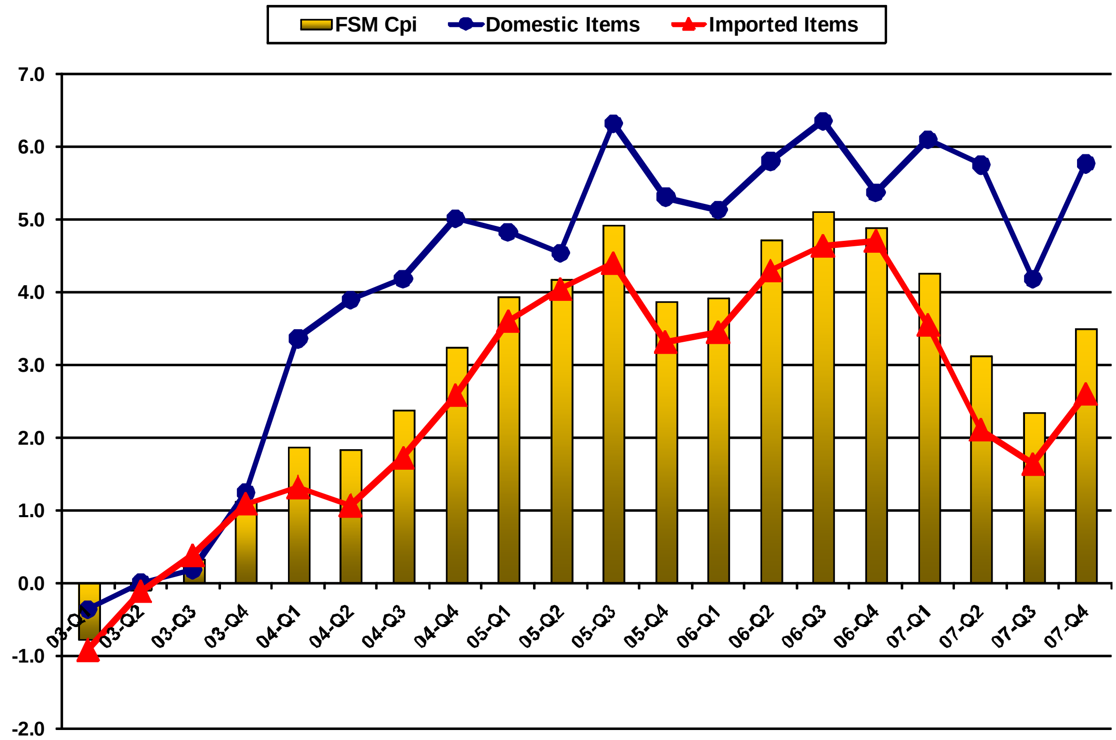


Figure 11 Change in Consumer Price Index - Domestic and Imported Items (year on year percent change)

meat, and poultry, increased significantly in FY2004, but have since moderated. The general increase in world food prices that occurred in 2008 is not reflected in the period under discussion in this review. The national government increased the tax on beer and tobacco in the first quarter of 2005 to compensate for a lack of revenues. This resulted in an approximate 10 percent hike in the prices of these items, which was reflected in the CPI in 2005 in all states with the exception of Chuuk, where the increased in tax rates did not filter through into any price increase until the second half of 2006. This reflects the weak tax administration in Chuuk state, a widely recognized phenomenon. The Compact I energy grant was used in Chuuk and Kosrae to subsidize energy prices, and its loss resulted in both states needing to raise electricity tariffs. In Pohnpei and Yap the state governments had adopted a cost recovery price basis of production and had ceased to use the energy grant to subsidize prices in the mid-1990s. Finally, the general increase in world fuel prices imparted significant inflationary pressure through most of the period pushing up both prices of gasoline at the pump and requiring increases in utility tariffs in all states. Overall inflation moderated in FY2007 to 3.6 percent down from the rate of 4.4 experienced in FY2006, as the earlier increases in food prices and taxes on cigarettes and beer worked their way through the system. While the very sizeable increases in fuel prices in 2008 are not reflected in the statistics under review, increases in energy prices remained the most significant element contributing to inflation in FY2007.

Money and Banking

44. With the adoption of U.S. currency in the FSM, macroeconomic policy and adjustment has been limited to the use of fiscal policy. The use of a foreign currency is practiced in many other small island economies of the Pacific and has served the FSM well. While the range of macroeconomic policy options is limited, it has removed the potential to use inflationary monetary policy to adjust to changes and reductions in Compact funding. Of course, this has left the FSM with no other means of adjustment to reduced levels of resource transfers other than through the more politically painful means of directly cutting government expenditures, reducing public sector employment and wages, and increasing domestic revenues. The use of a foreign currency has removed exchange rate realignment and devaluation to encourage the export and traded goods sectors of the economy. At this stage of the FSM economic development, with many underlying structural impediments, exchange rate adjustment without accompanying supporting policies would be unlikely to encourage a favorable supply response in traded goods production.

45. The lack of an independent monetary policy results in domestic interest rates being closely aligned with U.S. rates. Deposit interest rates observed in the market are broadly similar to those throughout the United States, while lending rates are generally higher, reflecting the additional risk and costs of doing business in the FSM. Initially, the higher rates charged on loans resulted in regulation and limits were placed on both consumer and commercial loan interest rates. As part of the Public Sector Reform Program, removal of regulation was recommended and was a loan condition. The interest rate limits were effectively removed (leaving only a non-binding usury limit at 24 percent) in 1998 and there was no adverse change in the local interest rate structure as the financial system was allowed to adjust to market forces.

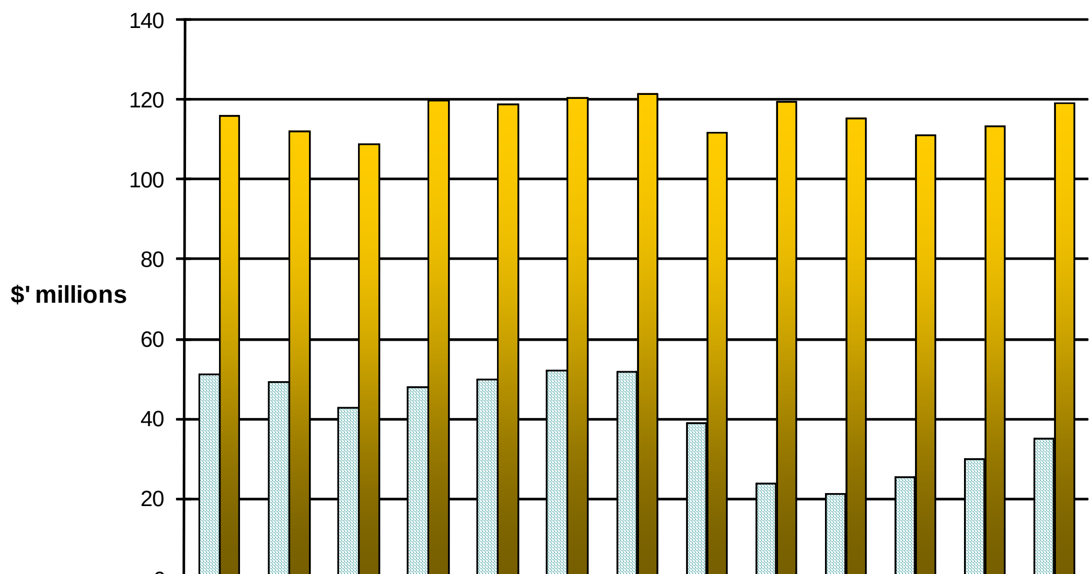
46. The FSM banking system benefits from the Federal Deposit Insurance Corporation (FDIC) as part of the provisions of the Compact. The FDIC has played a critical role in supervising the banking system and ensuring a sound and stable financial system. Under the amended Compact FDIC support remains effective, and will help maintain financial stability in the economy, and avoid the adverse consequences of banking system failures experienced in many other Pacific Island economies. The banking system is also regulated by the FSM Banking Board, which is developing a capacity for banking supervision. The role of the board includes licensing of domestic and foreign banks, on-site and off-site supervision of all banks, consumer protection, and consultation with the FDIC. Until December 2002, when the Bank of Hawaii withdraw from the market, there were two U.S. banks operating in the FSM. There is one locally owned bank, Bank of the Federated States of Micronesia. The remaining U.S. bank, Bank of Guam, is a branch of its parent, and thus also comes under U.S. federal supervisory requirements. The present system is thus well supervised and provides a secure basis for financial intermediation.

47. Early in 2002, Bank of Hawaii announced its intention to withdraw from the FSM and sell its local operations. Being the largest and most profitable bank in the economy, this decision was an unwelcome development. The decision apparently was motivated in

large part by broader corporate restructuring concerns as opposed to an isolated analysis of the FSM-based operations. The same bank had also recently completed divestiture of its South Pacific operations. In the depressed state of the FSM market Bank of Hawaii was unable to find an interested buyer, and was left with little alternative but to run down its operations. The closure of the bank, effective from November 30, 2002, appears to have occurred in an orderly fashion, but not without major macroeconomic disruption to the economy. The departure of a major player has reduced competition in the financial sector and entailed a loss of institutional knowledge that will take time to rebuild.

48. Statistics on the FSM banking sector commenced in 1990, but analysis commences in 1995 (see Figure 12.) With regard to deposits, the most striking feature is the lack of any growth in the deposit base in the long-term since September 1995. At the end of September 2007 the deposit base was only $3.2 million higher or 2.8 percent above the level at the end of September 1995. There was a dip in the series in 1996 and 1997, reflecting the Chuuk financial crisis, and again a run-off at the end of Compact 1 and in the first two years of the amended Compact period. In 2006 and 207 there has been modest growth in the deposit base, but overall deposits have remained remarkable constant. The lack of financial deepening during the period is consistent with the lack of growth in the economy.

49. Regarding lending, developments reveal a similar pattern through the end of



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Loans	51.3	49.3	42.9	48.1	50.0	52.4	52.0	39.1	24.0	21.3	25.7	30.0	35.3
Total Deposits:	116.3	112.3	109.3	120.0	119.1	120.8	121.7	112.0	119.8	115.4	111.4	113.7	119.5

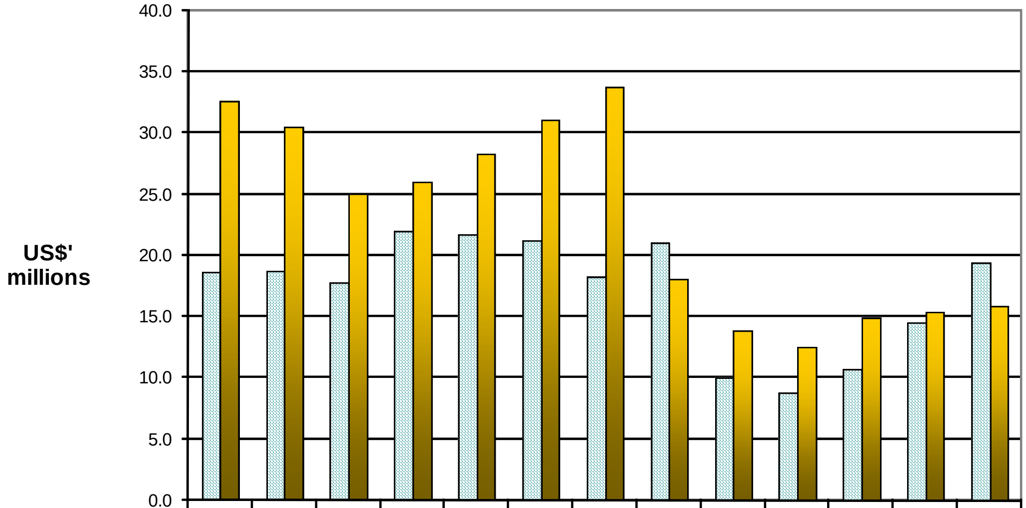
Figure 12 Commercial bank loans and deposits (end of period)

2001. The period starts with a cutback in lending as the banks progressively reduced their portfolio to $46 million through the third quarter of 1997, reflecting the second step-down and Chuuk financial crisis. By 1998, matters began to improve and the banks began extending credit once more, reaching a peak at the end of September 2001 of $52 million. In 2002 the Bank of Hawaii began implementing its plans to withdraw from the market. Outstanding bank credit fell precipitously in each consecutive quarter, declining to a level of $21 million at the end of September 2004. While the departure of Bank of Hawaii was implemented quietly without incurring adverse publicity, the bank failed to sell its assets to the two remaining banks. Neither Bank of Guam nor Bank of the FSM tried to capture the available business, preferring to leave the problem to the departing bank. While the Bank of the FSM was restructuring its portfolio at the time, the bank has since taken a more proactive stance and the level of outstanding credit in the system has grown by $14 million since September 2004 and stood at $35.3 million at the end September 2007.

50. The difference between loans and deposits indicates the large level of liquidity in the FSM banking system, and reinforces the widely observed phenomena in the Pacific Islands region that capital is not a factor of production in short-supply. Reflecting the trends described above, the loans to deposit ratio remained relatively constant, hovering around 39 to 44 percent until the departure of Bank of Hawaii. By the time of Bank of Hawaii's complete withdrawal from the market at the end of September 2004 the loans-to-deposits ratio had fallen to 18 percent. Since that time there has been some improvement in the situation and the loans-to-deposit ratio rose to 30 percent by the end of September 2007.

51. The large difference between the level of deposits and loans is invested offshore, and mirroring the reduction in credit following the departure of the Bank of Hawaii the level of foreign assets rose by approximately $26 million or 34 percent between September 2002 and September 2003. The rise in foreign assets and associated reduction in credit should imply that the FSM economy experienced a large macroeconomic shock during FY2003 as the extra liquidity was invested offshore. Surprisingly, the figures for FY2003 indicate that economy actually grew by 2.9 percent and do not indicate the impact of any adverse shock. The reduction in credit would have been offset to some extent by the infusion of funds from FEMA for typhoon rehabilitation in Chuuk, but a significant reduction in GDP would have been expected.

52. Reflecting a lack of "bankable projects" the commercial banks have generally preferred to extend credit to consumers with secure public sector jobs and an identified repayment stream. Lending to consumers traditionally represented about 60 percent of domestic credit creation. Consumer credit dropped off rapidly as the Chuuk crisis set in and with the second step-down in funding (see Figure 13.) With a return of more prudent fiscal policies in the state, consumer credit once again expanded. The impact of the departure of Bank of Hawaii was initially more adverse on the consumer market than on the business sector, although runoff of commercial loans followed suit shortly thereafter. The figures indicate that there has been some extension in consumer credit in recent years, but



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Commercial Loans	18.7	18.8	17.8	22.0	21.7	21.3	18.3	21.0	10.1	8.8	10.7	14.6	19.4
Consumer Loans	32.6	30.5	25.1	26.0	28.3	31.1	33.8	18.1	13.9	12.5	14.9	15.4	15.9

Figure 13 Commercial Bank Credit by Sector (end of period)

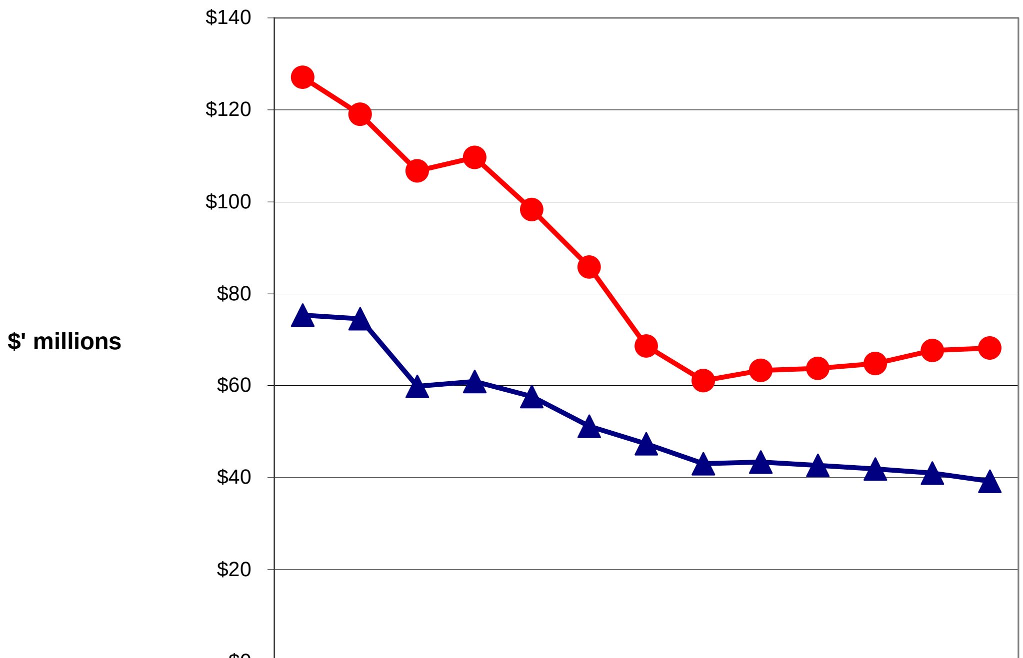
that it has failed to return to the levels of the 1990s. On the other hand commercial credit has grown rapidly since the departure of Bank of Hawaii, with the level of outstanding loans returning to the levels of the 1990s, reflecting more proactive lending polices primarily of the Bank of the FSM.

External Debt

EXTERNAL DEBT

53. Prior to FY1990 the FSM had no official public sector debts to offshore lenders. During the period FY1990 to FY1993 the nation underwent a rapid increase in external public borrowing. This borrowing included MTN bonds issued for $71 million to finance portfolio investments by Yap State, and $42.9 million for fisheries-related investments in Pohnpei, Chuuk, Kosrae and for the National Fisheries Corporation. Public guaranteed borrowing also included $41 million from the US Rural Electrification Administration by the FSM Telecommunications Corporation and $9 million by the Yap Fishing Corporation.

54. Figure 14 shows that the heavy borrowing by FSM governments brought the nation’s total official external debt to a level of $127 million at the end of FY1995, representing 57 percent of GDP in that year. The only significant borrowing that has been undertaken since FY1994 has been through the concessional lending facility of the Asian Development Bank. The FSM external debt level has shifted from a position that was, in



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
External Debt	127.1	119.0	106.7	109.7	98.3	85.8	68.6	61.1	63.3	63.7	64.8	67.6	68.2
Adjusting for offsetting Assets	75.4	74.5	59.9	61.0	57.6	51.1	47.4	43.1	43.3	42.7	41.9	41.0	39.2

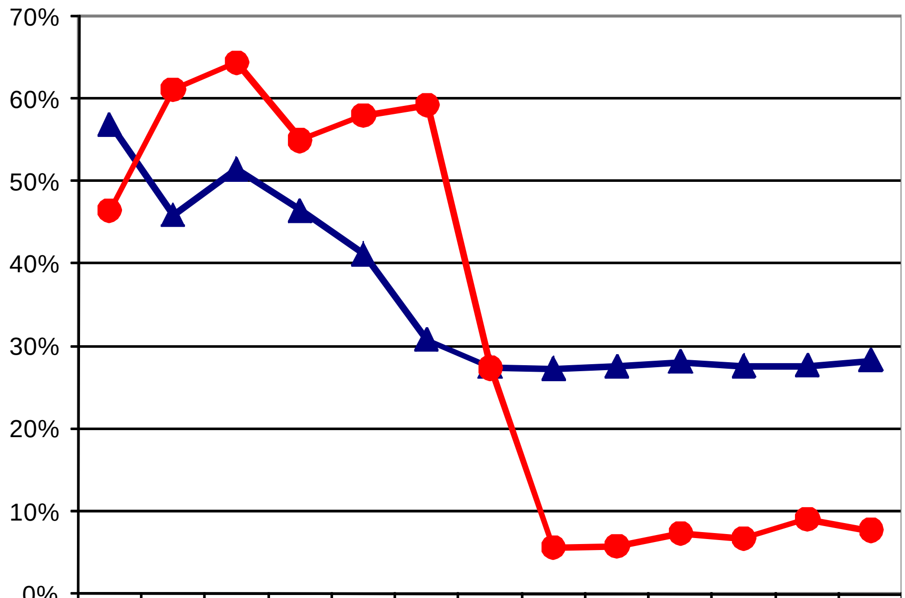
Figure 14 FSM External Debt (US$ millions)

the early 1990s, quite adverse, to one that is now favorable. The completion of the Medium Term Note program with final repayments taken from Compact revenues in FY2001 has resulted in this desirable outcome. With a debt-to-GDP ratio of just 28 percent in FY2007, the FSM's debt level is low by Pacific Island standards (see Figure 15 and Table 6b in the Statistical Appendix). Furthermore, with the remaining debt on concessional terms, the debt service ratio in FY2007 is projected at the low level of 8 percent of exports of goods and services. Each of these ratios is somewhat overstated in light of the fact that the FSM holds a sinking fund equal in value to the amount outstanding for the PSRP, PSD and BSS loans from the ADB. Adjusting for this asset held against external debt, the debt-to-GDP ratio in FY2007 would be 16 percent, and the debt service ratio 6 percent of exports of goods and services.

Fiscal Developments

Fiscal Policy Framework

55. The original Compact which became effective in FY1987 provided for the transfer of resources in three essential areas: funds to support general government, which were largely unrestricted, special grants tied to specific sectors, and access to U.S. special and federal programs. The flow of resources entailed two step-downs in five yearly intervals



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
External Debt, % of GDP	57%	46%	51%	46%	41%	31%	27%	27%	28%	28%	28%	28%	28%
Debt Service, % of Exports	46%	61%	64%	55%	58%	59%	27%	6%	6%	7%	7%	9%	8%

Figure 15 FSM external debt ratios

in FY1992 and FY1997, and an increase in funding in FY2002–FY2003 at the average levels of the first 15 years. Of the different grants some were inflation indexed at two-thirds of the U.S. GDP deflator and some were not indexed. The structure of the original Compact, due to the fungibility of the resources, placed no effective constraints as to which sectors the resources were directed. However, the original Compact entailed the need for two large fiscal adjustments coinciding with the two step-downs and the challenge of how to “sterilize” the bump-up in resources in the final two years in FY2002 and FY2003.

56. The agreement and adoption of the amended Compact by the FSM and U.S. governments became effective in FY2004 and initiated a wholly new fiscal framework on the FSM. The structure entailed a series of sector grants earmarked for education, health, environment, private sector development, capacity building, and infrastructure. The innovative nature of the amended Compact was the introduction of a trust fund, which was designed to provide a yield sufficient to replace the annual grants after 20 years. Table 6 indicates the aggregate structure of the annual Compact grants and the contribution to the Compact Trust Fund. Each year over a 20-year period the United States will contribute to the FSM $92 million partially adjusted for inflation. The inflation adjustment factor remains as in the original Compact. The annual sector grants start a level of $76 million in FY2004, but are to be annually reduced by a $0.8 million decrement from FY2007 on-

Table 6 U.S. annual Compact grants and contributions to the Trust Fund

	Annual Grants	Trust Fund Contribution	Total Contribution
FY04	76.0	16.0	92.0
FY05	76.0	16.0	92.0
FY06	76.0	16.0	92.0
FY07	75.2	16.8	92.0
FY08	74.4	17.6	92.0
FY09	73.6	18.4	92.0
FY10	72.8	19.2	92.0
FY11	72.0	20.0	92.0
FY12	71.2	20.8	92.0
FY13	70.4	21.6	92.0
FY14	69.6	22.4	92.0
FY15	68.8	23.2	92.0
FY16	68.0	24.0	92.0
FY17	67.2	24.8	92.0
FY18	66.4	25.6	92.0
FY19	65.6	26.4	92.0
FY20	64.8	27.2	92.0
FY21	64.0	28.0	92.0
FY22	63.2	28.8	92.0
FY23	62.4	29.6	92.0

ward. The difference between the total contribution and the annual sector grant levels will be deposited in a trust fund to accumulate over the 20-year Compact period.

57. In comparison with the original Compact the new regime avoids the need for large fiscal adjustments every five years. However, in order to establish the viability of the trust fund, the United States instigated the annual decrement. While avoiding large shocks to the system, the decrement will still require an annual compression of expenditures from FY2007 onward. Coupled with the lack of full inflation adjustment, the annual reduction in real resources, estimated to be approximately 2 percent per annum, will require active fiscal policy adjustments unless a policy regime can be developed sufficiently attractive to encourage private sector investment and economic growth great enough to offset the decline. The sectoral structure of the Compact also presents special problems. In the FY2004 budgets the altered fiscal framework resulted in funding shortages for the operations of government not covered under the sector grants. In order to address the shortfall, the United States permitted the FSM to utilize the capacity building sector grant for this purpose, provided the FSM agreed to transition out the use of the grant for “non-conforming” purposes over a five-year period. Under duress the FSM had no alternative but to concede. While the operation of the FY2004 budgets were not affected, the transition requirements became binding in FY2007 and require a painful adjustment of expenditure cuts or increased revenue effort.

58. At the FY2005 Joint Economic Management Committee (JEMCO) meeting in August 2004, it was resolved that the FSM must allocate at least 30 percent of Compact sector grants to the infrastructure grant effective from FY2006. The FY2005 infrastructure requests were considered below desired levels, and JEMCO felt a floor should be established to ensure that public investment was maintained at sufficient levels to support the development of the economy as aggregate Compact resources were projected to decline. This requirement induced substantial reprogramming in Pohnpei and Yap states in their FY2006 budget submissions. Access to federal programs is to continue during the amended Compact with the exception of certain education programs, which were "cashed out" and have been replaced through the Supplemental Education Grant (SEG). Finally, implementation of the amended Compact entails a whole new accountability regime that is specified in the Fiscal Procedures Agreement (FPA). Taken as a whole the new fiscal arrangements of the amended Compact will have a wide-ranging impact on the conduct of fiscal policy and management in the FSM.

59. Fiscal policy has been formulated in each of the national and four state governments with separate expenditure and revenue policies in the absence of significant coordination. With respect to revenue policy, the national government has the power under the constitution to collect import and income taxes, and all remaining taxes are reserved for the states. Through its taxing powers the national government collects about three-fourths of all domestic taxes. In FY2007 national taxes amounted to $21.1 million, while the four states collected an additional $6.8 million. The states, with widely varying levels of tax effort, collect the remaining one-fourth of domestic taxes, primarily through general sales taxes and excise taxes on alcohol, tobacco, and other goods.

60. By constitutional mandate at least 50 percent of the nationally imposed taxes (and 80 percent of the fuel import tax) must be shared with the state in which the taxes were collected. At the start of FY1999, the national government shared a further 20 percent with the states, although the use of these extra transfers, amounting to about $4.3 million annually, was restricted to health and education capital projects. In FY2004, as the fiscal position tightened with the implementation of the amended Compact, the national government legislated the return of the 20 percent. While overall tax effort remains low relative to other Pacific Islands, there has been some gradual increase over time. In FY2007 tax revenues equate to 11.7 percent of GDP as compared to roughly 10.8 percent, the level that prevailed throughout most of the Compact I period from FY1987–2003. The small increase reflects primarily a policy change to the import tax that shifted the base from f.o.b. to c.i.f., and increases on beer and tobacco effective FY2005, but was offset in FY2007 by deductions allowable against the Gross Receipts Tax for payroll costs. While it is likely that there has been a modest improvement in collection performance, tax administration and, in particular, compliance and audit functions remain in need of rigorous reform.

61. With respect to non-tax revenues, these continue to be dominated by fishing access fees, which recently have represented nearly one-quarter of all domestic revenues.

The national government manages the tuna resources and keeps all revenues from the licensing fees. Revenue from penalties and fines is shared with specific states and, in some cases, local governments. The fishing access fee source of revenue grew rapidly from less than \$4 million in FY1987 to a peak of over \$21 million in FY1995, but has subsequently dropped back and averaged \$13.4 million during the amended Compact period. The declining trend in this revenue source is the leading cause of the deterioration in the national government's fiscal position.

62. During Compact I the national government acted as an agent in distributing to each government, according to mutually agreed formulas, the grant funding received from the United States under the Compact. The national government received just less than 15 percent of current grants and 10 percent of capital grants. The remainder was distributed to the states based roughly on a formula that split 30 percent of funding evenly among the four states and 70 percent of the funds according to population. The formula shares were developed prior to the start of the Compact assistance and remained unchanged throughout the 17 years of Compact I assistance. With the advent of the amended Compact there was a general census that the formula should be revised to provide a greater share to the states where fiscal pressure was greatest. At a meeting of the Economic Policy Implementation Council (EPIC) in October 2003 the formula was revised, reducing the share of the national government to 8.65 percent and distributing the remainder in a similar proportion to original distribution amongst the states. However, with mounting fiscal pressure on the national government, the Congress of the FSM legislated in 2005 that no less than 10 percent would be allocated to the national government effective from FY2007.

63. On the expenditure side of fiscal policy, the five governments all operate within "balanced budget" requirements based on either constitutional or statutory provisions. However, the definition of a balanced budget is not restricted to the operations of a single budget year. Funds unexpended in one year are reported as revenues in the following year. The use of this so-called "carry-over" component in revenue projections tends to cloud fiscal management and can mask the onset of significant structural imbalances. The vulnerability to fiscal imbalance is compounded by delays in financial reporting and expenditure controls that result in legislative bodies taking appropriation actions without an accurate appraisal of each government's true fiscal position being readily available.

64. The national and state governments conduct budgetary operations through a series of separate funds, the most important being the general fund, special fund, and capital fund. Expenditures from the general fund are largely unrestricted in nature, but there is limited flexibility or authority to use funds from the special and capital funds. Under Compact I a major part of the external assistance provided revenue to the general fund. Under the amended Compact all such receipts are recorded as either special or capital funds. Thus, standard Government Financial Statistics (GFS) reporting, aggregating across funds and accurately distinguishing between "above-the-line" revenues and expenditures and "below-the-line" financing operations do not always highlight some of the

additional constraints faced by fiscal policy makers. The best example of this was in Chuuk, which experienced severe financial crises in the mid-1990s and again in the early 2000s. The crisis was one affecting the general fund in particular, despite the fact that the state was running large surpluses on the capital fund and an overall fiscal surplus.

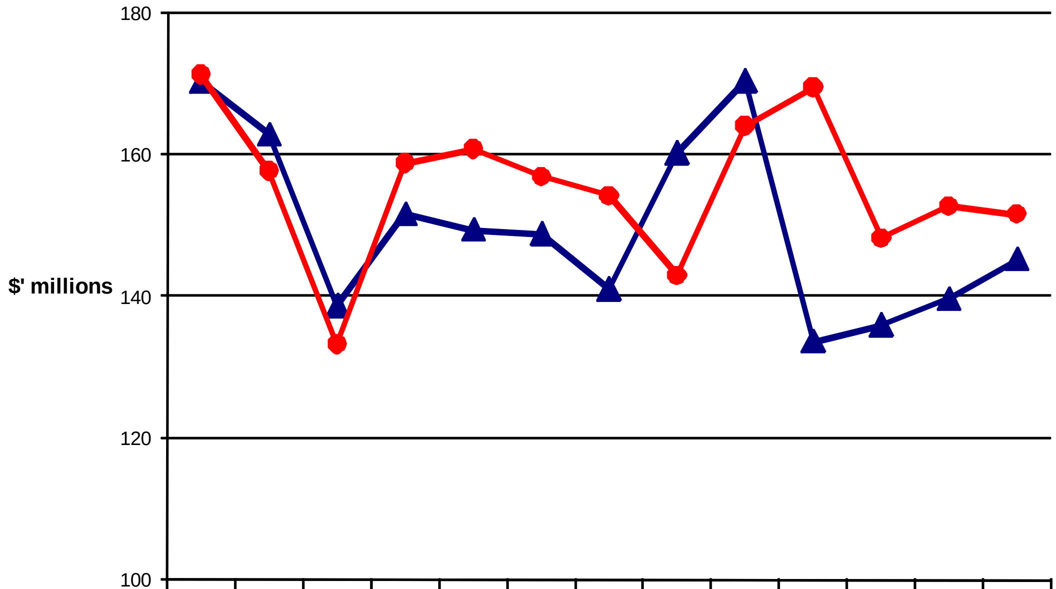
65. Fiscal analysis in the FSM has been hampered by the lack of timely and comprehensive financial reporting by the five governments. It was standard practice for audited information not to be available until 2 years after the closeout date. However, in the August 2005 JEMCO meeting a deadline was set that final audits should be available by June of the following year. At the end of June 2008 final audits for FY2007 were complete for all states and the national government for the first time.

66. Tables 7a-f in the Statistical Appendix show the fiscal performance on a consolidated basis and for each of the five governments. The presentation follows the standard Government Financial Statistics (GFS) format. Tables 8a-e show fiscal performance of each of the five governments in the audit format. This latter format provides fund balances for each of the three main funds and, as noted above, does not report financing items below the line.

Recent Fiscal Performance

67. Figure 16 indicates the major trends in fiscal performance for the FSM (consolidating the five government accounts) since FY1995. At the start of the period before the second step-down, revenues and expenditures were largely in balance and the economy achieved fiscal balance. However, from FY1998 through FY2001, after the second step-down the fiscal account came under severe pressure as the nation was forced to adjust to a significant loss in revenues; the overall fiscal balance recorded an average deficit of 5 percent of GDP. The fiscal deterioration was compounded by a loss in fishing fee revenues that fell from an average of $21 million per annum between FY1995–FY1996, to $14 million between FY1997–FY2001. The large recorded deficits were financed through draw down of savings accumulated during the early phase of the Compact.

68. The second step-down in funding precipitated the need for a public sector reform program whose primary objective was fiscal stabilization. Fiscal stabilization was achieved through two major means: reductions in expenditures through an Early Retirement Program (ERP) and revenue reform. While the major element of adjustment (85 percent) was achieved through expenditure reduction, changes to the customs regime making all importers subject to the tax and switching the basis of collection from an f.o.b. to c.i.f. basis made a significant contribution. However, despite restoration of fiscal balance in Kosrae, Pohnpei, and Yap states, Chuuk and the national government recorded significant deficits between FY1997 and FY2001. In the case of the national government continued non-recurrent expenditures on constituency based projects were funded through draw down of past savings. While similar trends were evident in Chuuk, the primary cause was financial mismanagement and a large accumulation of arrears to vendors.



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07
Revenues	170.3	162.9	138.7	151.6	149.4	148.8	141.1	160.3	170.4	133.6	135.9	139.7	145.2
Expenditures	171.3	157.7	133.2	158.8	160.8	156.9	154.2	143.0	164.1	169.5	148.2	152.8	151.6

Figure 16 FSM consolidated revenues and expenditures

69. Returning to Figure 16, the FSM fiscal accounts recorded overall surpluses during the two bump-up years in FY2002 and FY2003, as the nation was required to save the excess funds to contribute to the amended Compact Trust Fund. However, in FY2004, at the start of the amended Compact period, the nation appeared once again to shift back into deficit as funding returned to levels below those prevailing before the pre-bump-up period. The large reduction in funding in FY04 onwards represents not only the lower aggregate level of Compact funds, but also capacity constraints with implementation, both relating to the recurrent sector grants and failure to establish compliant procedures for the draw down of the infrastructure grant. In FY2004 all governments were required to make payments to the amended Compact Trust Fund equivalent to $28.3 million. After deduction of the Trust Fund contributions from the overall deficit of $36 million, an underlying deficit of $7 million more accurately reflects the fiscal position in that year. In FY2005 and FY2006 the FSM recorded deficits of $12 and $13 million, respectively representing 5 percent of GDP, and indicates the difficulties in adjustment. By FY2007 as efforts to adjust start to take hold, the fiscal position improved and the deficit fell to $8 million or 3 percent of GDP.

70. Reviewing the structure of the fiscal accounts on a consolidated basis one can see the extensive dependence on external grants as well as the trend toward reducing that dependence. As shown in Table 7 grants represented 54 percent of GDP in FY1995,

Table 7 Comparative analysis of fiscal structure FY1995, FY2001, and FY2007

[redacted]

Notes 1 State GDP is used as the divisor for each of the four states, and FSM GDP is used as the divisor for the national government and consolidated account

2 Taxes include all taxes collected in each state irrespective of the revenue sharing arrangements.

equated to 43 percent in FY2000 near the end of Compact I, and are estimated at 37 percent in FY2007. However, the figures in future years will revert to higher levels as the nation overcomes capacity bottlenecks and draws down on the infrastructure grant. Government expenditures have also declined as a share of GDP from a level of 82 percent in FY1995 to an estimated level of 70 percent of GDP in FY2000, and are projected at 64 percent for FY2007. While expenditures will rise for the reasons just outlined, the dominance of government in the economy has been reduced. On the revenue side the change in structure has been less dramatic and the relative importance of grants and domestic revenues has changed little. Grants made up some 64 percent of government revenues in FY2007, down slightly from the level of 66 percent in FY1995. Tax effort as a share of GDP has grown from 10 percent in FY1995 to 12 percent in FY2007. The most prominent change in the structure of revenues has been the reduction in fishing access fees, which reached a peak of $21.5 million in FY1995 and averaged $13.4 million annually in the FY2004–FY2007 period.

National Government

71. At the beginning of the period in FY1995 and FY1996 the national government was running a fiscal surplus. The impact of the second step-down in FY1997 altered this situation. Coupled with a large reduction in fishing access fees, which was to become the norm in subsequent years, the fiscal position of the national government deteriorated significantly. The combined revenue losses, together with a failure to reduce current expenditures, created an overall deficit of 5 percent of GDP in FY1997.

72. The fiscal performance of the national government was a serious concern during the FY1997–FY2001 period as it ran large overall deficits in the range of 4 to 6 percent of GDP or an average annual level of $10 million. These deficits were largely funded from surplus balances accumulated in prior years—in effect by drawing down portfolio assets from abroad. Through the ERP the national government reduced payroll costs by about $1 million, and achieved about 50 percent of the intended target reduction. However, these cost-saving measures were clearly minor in terms of the magnitude of the problem. In FY1999 the national government conceded to increase the share of revenues allocated to the states from 50 to 70 percent after the state governments had unsuccessfully managed through legal action to attain any share of the fishing fees. This loss of revenue amounted to about $4 million annually or 2 percent of GDP.

73. During FY2002 and FY2003, it became increasingly apparent that such deficits were no longer sustainable and expenditures on public projects had to be severely curtailed. However, the adjustment was insufficient and the national government continued to run deficits of 1 and 2 percent of GDP in each of the two years respectively. At a meeting of the EPIC in FY2003 the states had pressed for a greater share of Compact revenues and the share of the national government was reduced from 13.3 to 8.65 percent, effective in FY2004. With lost revenue on several fronts the Congress of the FSM legislated to restore the lost 20 percent revenue share in FY2004 and an underlying surplus (removing the $8 million contribution to the Compact Trust Fund) of 0.7 percent of GDP was recorded.

74. At the beginning of FY2005 the national government further legislated to set the minimum share of Compact resources at 10 percent to be effective from FY2007. In early 2005 legislation was passed to implement additional tax measures to increase revenues on beer and tobacco. However despite these measures the fiscal position remained in deficit and the national government recorded deficits of $1.6 and $6.1 million in FY2005 and FY2006, respectively. In FY2007 the national government implemented tax measures to provide relief to the private sector through allowing firms to offset payroll costs in the calculation of the Gross Revenue Tax. However, despite the loss of revenues the fiscal position strengthened as the allocation of the additional Compact resources came into affect and with a sizeable additional receipt of $5 million of U.S. federal grants. In FY2007 the national government recorded a deficit of $2.3 million or 1 percent of GDP.

Chuuk State

75. Financially, Chuuk State has been the least well-managed of the five FSM governments. The impact of the reduction in Compact grants in FY1997 required a particularly difficult adjustment, and expenditures were cut in FY1997 to just $25.8 million from a level of $42.4 million in FY1995. Cuts in staffing and working hours (from 80 to 64 hours per pay period) achieved through the ERP resulted in reductions in payroll expenditures from a peak of $21.9 million in FY1995 to $12.8 million in FY1998, and reflected a 42 percent cut. The return to fiscal discipline in Chuuk from FY1997–1999 was

a significant achievement and sufficient to repay arrears and to support a substantial economic recovery.

76. However, immediately upon achieving recovery, the state returned to many of the same poor fiscal practices that led to the original financial crisis. The state restored half of the working hour cut, up from 64 to 72 hours bi-weekly at the start of FY2000 and the remaining 8-hour increase in FY2001. The impact of this return to full hours, combined with new hiring, contributed to an increase in payroll costs to a level of $19.5 million in FY2002. Yet even with the upward adjustment in payroll, much of the return to fiscal crisis in FY2000 and FY2001 can be attributed to an increase in other discretionary spending for constituency-based projects and increases in legislative allowances and expenses coupled with similar indiscipline in executive branch discretionary spending. While the overall deficit in FY1999 was primarily a result of a doubling of capital expenditures to finance the renovation of the state airport, subsequent deficits in FY2000 and FY2001 resulted directly from a lack of fiscal discipline.

77. During FY2002 and FY2003 the state recorded two years of fiscal surplus resulting from the receipt of bump-up funds and had to set aside the increase for the amended Compact Trust Fund. In FY2004 through FY2006 due to difficulties adjusting to the new regime of the amended Compact and lack of financial discipline the state once again moved back into deficit registering overall deficits of $12.8, $5.8 and $5.7 million, respectively or 19, 9 and 8 percent of state GDP in each period. In FY2007 Chuuk was required to make the first of 3 annual reductions in non-conforming uses of the Compact capacity building sector grant amounting $0.9 million. The adjustments to the new conditions of the amended Compact were making their impact and state GDP fell by 9 percent and State tax revenues fell in tandem by $0.8 million. However, despite the reductions in revenue, state expenditures were cut back very significantly from a level of $37.7 million in FY2006 by $8.3 million. As a result the fiscal position improved significantly and the state recorded a deficit of $0.9 million or 1 percent of GDP the lowest level since the start of the amended Compact period.

78. With current accumulated debts said to be in excess of $40 million the state is in effect insolvent. Unlike prior financial crises in which Compact funds could be set aside to repay creditors, the current structure prohibits the use of the new sector grants for reasons other than conforming to the purposes stated. Restoration of solvency can only be achieved through savings of local revenues, which are under considerable stress already to fund activities that are no longer eligible for Compact sector grants.

Kosrae State

79. Kosrae has maintained relatively consistent fiscal balance throughout the period FY1995–FY2003. The state had a current deficit of about 7 percent of state GDP in FY1997 as a result of the reduction in Compact grants and delay in implementing expenditure cuts. While current expenditures were subsequently reduced and current balance restored, the emerging deficit of 4 percent of GDP in FY2001 led to concern that further

fiscal tightening was required. Payroll levels had not been reduced as significantly in Kosrae as in other states, despite implementation of a 56-hour pay period in FY1997. Payroll costs had been cut from a peak of $5.8 million in FY1996 to a level of $4.6 million in FY1999, a nominal cut of over 20 percent. However, a mandated annual step increase of 5 percent provided significant upward pressure on the state wage bill, and in FY2002 the state was able to accommodate a large increase in payroll expenditures and return to a 64 hour bi-weekly payroll as the state benefited from the large increase in revenues from the bump-up funds. The payroll for FY2003 stood at $6.2 million, 8 percent above the pre-reform peak.

80. These developments left the state in an unenviable position at the start of the amended Compact. In effect the modest current surplus in FY2002–FY2003 was less than the bump-up, and provided a clear signal that, with respect to medium-term fiscal policy, the state had a structural deficit and would have to undergo another period of painful adjustment. The structure of Kosrae State's fiscal accounts have been transformed the least of any of the five FSM governments, tax effort is weak, and the local economy is the most dependent on Compact revenues. These features indicate a lack of flexibility in adjustment options to the new provisions of the amended Compact. In FY2004 the state experienced cash flow management problems, revealing an underlying stressed fiscal position, and after adjusting for the contribution to the Compact Trust Fund a structural deficit of $3.8 million or 21 percent of state GDP was recorded. Matters failed to improve in FY2005 and FY2006 and the state continued to experience overall deficits of $1.2 and $1.5 million or 7 and 8 percent of GDP, respectively.

81. In FY2007 the state began to put its house in order. Mid 2007 the state convened a leadership conference and adopted a program of reform (describe in the next section) to increase state revenues and phase out in an orderly manner non-conforming uses of the Compact capacity building sector grant. While the reduction in payroll costs did not impact the FY2007 fiscal position and the state increased local taxes, and revenues rose from $0.1 in the previous year to $0.6 million, a very significant effort. These beneficial developments were offset by a very substantial reduction of $1.5 million in federal programs arising resulting from a shift to the new Special Education Grant or SEG. Despite the overall negative impact on revenues, the state managed to make a large reduction in outlays on goods and services although payroll costs remained unaffected. As a result the state recorded an overall surplus of 1 percent of GDP amounting $0.1 million.

Pohnpei State

82. Pohnpei State has shown considerable fiscal discipline from FY1996 to the present. As with Chuuk State, the GFS presentation masks some budgetary problems that were faced with respect to the general fund, but even with that the state appears to have adequately adjusted to current resources. Payroll costs were reduced from their peak of $17.9 million in FY1996 to a low of $13.6 million in FY2001. A return to the normal 80-hour working week was possible in FY2003 without threatening fiscal balance and the wage bill rose to $15.2 million. More than any other state, Pohnpei responded signifi-

cantly to the adjustment challenge by increasing state tax revenues. State taxes have nearly doubled from $1.4 million in FY1997 to a level of $2.8 million in FY2007, and total tax revenue as a share of state GDP has increased from 6 to 7 percent during this period despite a return of the 20 percent revenue share to the national government. In FY2004 a deficit of $5.5 million or 5 percent of GDP was recorded. However this outturn hides the state's contribution of $7.5 million to the Compact Trust Fund (CTF) and an unusual increase in non-tax revenues of about $5 million. Adjusting for these non-recurring features suggests the state ran a deficit of $2.9 million or 2.5 percent of GDP. In FY2005 a small deficit of $0.1 million was recorded and a surplus of $0.3 million was recorded in FY2006.

83. In FY2007 state revenues remained largely unchanged on the previous year although reductions in non-tax revenues were offset by increases in federal grants. While payroll costs were reduced slightly, large increases in outlays on goods and services resulted in the state incurring an overall deficit of $1.0 million equivalent to 1 percent of GDP. Given that the state is not required to phase out any non-conforming use of the capacity building sector grant, it is much better placed to face the coming development challenges than either Chuuk or Kosrae. Unfortunately, the inward looking and weak policy environment will need rectification before the state can expect to experience a return of economy growth.

Yap State

84. During Compact I and the FY1995–FY2003 period Yap State showed the most consistent fiscal performance within the FSM, and recorded an average surplus of 11 percent of GDP throughout the FY1997–FY2003 period. Adjustment to the second step-down in FY1997 was done in an impressive manner, and payroll costs were reduced from a peak of $7.3 million in FY1996 to an estimated $5.3 million in FY2000, a cut of 27 percent in nominal terms. Tax revenues as a percent of GDP have been variable, reflecting years of growth and stagnation. A key component of the state's fiscal situation has been the success of the state's monetization scheme. In FY1991 the state borrowed $71 million through the issuance of MTN bonds secured by future Compact assistance flows under full faith and credit provisions provided for in the Compact Treaty by the U.S. government. Having borrowed at a weighted average interest rate of 8.5 percent, the state has received investment earnings in excess of the cost of borrowing, which is reflected in investment balances in FY2007 of $61 million.

85. In the amended Compact period FY2004–FY2007, under a new administration fiscal performance has deteriorated and after adjusting for the contribution to the Compact Trust Fund, the state recorded overall deficits of $2.3, $3.6, $2.3 and $3.8 million or 6, 9, 6 and 9 percent of GDP in the four fours, respectively. After many years of fiscal discipline, pressure to increase wages resulted in a significant increase in payroll costs. While some of this was due to rehabilitation after Typhoon Surdal with the infusion of FEMA funds, a significant component was represented by increases in operating expenditures. In FY2006 payroll costs reached a level of $8.4 million significantly above the

level of $7.3 million recorded before the ERP and reforms in FY1996. In FY2007 these costs were cut back to $7.6 million as expenditures fell back to normal levels. Not only have payroll costs grown but also outlays on goods and services have expanded even more dramatically from a level of $7.6 million in FY03 to $11.3 million in FY2007.

86. In order to fund the persistent deficits that have emerged since the introduction of the amended Compact period, Yap state has made recourse to its substantial investments to sustain levels of expenditure about current revenues. The level of deficit is likely to increase in FY2008 and FY2009 as the state is required to transition out the use of non conforming uses of the Compact capacity building sector grant. Fortuitously the annual earnings and increase in market value of the state's investments has outgrown the draw down of funds to finance the annual deficit. However, the state has yet to design and implement an investment fund strategy, outlining what are the permissible economic and sustainable uses of its resources. Clearly, a sound policy is needed if the state wishes in the long term to avoid an undisciplined draw down of resources, which have been arduously built up to provide for the well being of future generations.

POLICY DEVELOPMENTS, PROSPECTS, AND ISSUES

Public Expenditure Management

PUBLIC SECTOR REFORM

87. A major objective of the Compact has been the attainment of economic self-reliance. However, at the beginning of the Compact I period the policy environment was hostile to the private sector, inward-oriented, and supported large and growing governments—a truly unfortunate policy mix for the support of economic development and attainment of the goals enshrined in the Compact. With the coming of the second step-down, the recognition emerged in 1995 that matters needed to change. The First FSM Economic Summit resulted in a consensus on policy reforms, and with the assistance of the ADB through the Public Sector Reform Program (PSRP), a series of reforms were implemented by the FSM states and national governments.

88. While a full review of the PSRP, which was evaluated by the ADB, is not called for, a brief assessment is warranted because the program attempted to reform many of the major policy areas which would be considered essential for an economy seeking to improve its economic performance. The goal of the PSRP was the transformation and development of a more efficient FSM economy. Its purpose had two dimensions: (1) reforming and reducing the size of the public sector to adjust to declining external resource transfers, and (2) shifting the balance of economic activity away from the public to the private sector. Five outputs were specified: (1) reduced size and operating cost of the civil service; (2) increased domestic revenue generation; (3) restructured government operations and public enterprises, with the divestiture of some of the latter; (4) successful mitigation of negative social and economic impacts of the adjustment in public expenditure; and (5) improved conditions for private sector development.

89. The achievement attained with reduction in workforce and payroll costs under the PSRP through April 2006 is indicated in Table 8.. From an initial target to save 35 percent of payroll costs, the five governments of the FSM attained 25 percent by the time of the PSRP closeout in December 1999. By early 2007, more than six years later, there had been some slippage and the rate of cost savings had slid back from 25 to 20 percent. Compared with the original target set in 1996 current annual payroll savings is $11.1, which remains a very substantial amount. Performance at the state level indicates marked differences. Yap State has been one of the best performers, which until the close of FY2004 had surpassed and maintained costs within target. However, with implementation of the amended Compact, there has been some erosion of Yap's normal commitment to fiscal discipline and both payroll numbers and costs have risen. The implementation in Pohnpei has taken a somewhat similar track, which largely sustained the progress attained at PSRP closeout. With implementation of the amended Compact, however, significant additional recruitment has taken place in education. As a result the target, cost savings in Pohnpei is now approximately half the wage bill target.

Table 8 PSRP workforce and payroll reduction performance (progress at loan closing December 1999 and April 2006)

	Workforce Reduction Target	Workforce Reduction Dec-99	Workforce Reduction Apr-07	Wage Bill Reduction Target	Wage Bill Reduction Dec-99	Wage Bill Reduction Apr-07	Annual Payroll Savings (US$)
Chuuk	-29% (2,784 ==> 1,963)	-24% (2,784 ==> 2,151)	-20% (2,784 ==> 2,234)	-44%	-31%	-25%	5.0 million
Kosrae	-14% (712 ==> 610)	-20% (712 ==> 628)	-24% (712 ==> 538)	-26%	-11%	-11%	0.6 million
Pohnpei	-28% (1,316 ==> 952)	-19% (1,316 ==> 1,069)	-3% (1,316 ==> 1,275)	-37%	-25%	-18%	2.8 million
Yap	-30% (940 ==> 661)	-33% (940 ==> 621)	-23% (940 ==> 719)	-29%	-34%	-27%	1.7 million
National	-21% (642 ==> 507)	-7% (642 ==> 600)	-7% (642 ==> 598)	-21%	-15%	-10%	1.0 million
FSM	**-27% (6,394 ==> 4,693)**	**-22% (6,394 ==> 5,069)**	**-16% (6,394 ==> 5,363)**	**-35%**	**-25%**	**-20%**	**11.1 million**

90. The national government, while performing poorly in terms of workforce numbers, achieved a significant reduction in cost savings, primarily through the near elimination of overtime payments. Chuuk achieved a high degree of success through the end of the PSRP program, but the fiscal crisis of the early 2000s undermined commitment and led to an increase in costs and hiring of contract workers. With the implementation of the amended Compact, a new administration, and after some backward movement payroll costs were forced more into line with fiscal realities—employment of contract workers was reduced and the 80-hour by-weekly pay period reverted to 72 hours. Despite the current problems, Chuuk's performance has made the largest contribution to the overall reduction in payroll costs. The result in Kosrae was the most disappointing. While exceeding the target reduction in workforce by a significant proportion, the state subsequently allowed the savings in payroll to be almost completely eroded. Annual increments and an increase in wage rates through a return to a 64-hour pay period were made possible through use of the bump-up funds. However, the onset of the amended Compact and need for the capacity building transition has significantly eroded the state's fiscal position and the former expansion in payroll was no longer sustainable and compression became unavoidable. There has thus been some improvement in Kosrae's position since FY2005 and both the workforce and payroll costs have been cut back. Overall at the FSM level, success in reducing payroll costs have been noteworthy and sustained although there have been some significant setbacks. It is worth noting that an amount equal to the entire original borrowing for the PSRP program loan, a total of $18 million for the FSM as a whole, was sterilized during the years in which payroll cost reductions were realized after the civil service retrenchment exercise was implemented. That $18 million amount was placed in escrow and is currently committed to pay for the original loan and two subsequent loans (PSD and BSS). As such the costs of the program were fully recovered, un-

der the management of the national government, in a timely manner and in proportion to the realized savings from payroll cuts.

91. The major focus of the PSRP was the downsizing of the government sector through the ERP, but the program also emphasized other areas of public sector reform, restructuring, and private sector development. While there was an intentional emphasis on expenditure compression, important revenue reforms were achieved through shifting the collection of import taxes from an f.o.b. to c.i.f. basis and broadening the system through levying import duties on all sectors of the economy, both private and public. Revenue targets were met or exceeded by the end of the program period, and consolidated tax revenue was 27 percent higher on average in the 4-year period FY1998–FY2001 than in the previous 4 years. Exports were exempt from gross revenue taxes consistent with adoption of an "outward"-looking development strategy. However, the revenue reforms were intentionally undertaken within the existing regime rather than through adoption of a modern administration and tax system such as required through the implementation of a VAT. Tax reform is currently an active area of policy reform and is discussed in the section on private sector development (see p.61).

92. The PSRP also addressed the need for restructuring of government operations and public enterprises, but progress has been slow and only recently has any significant transformations been undertaken. A subsequent attempt at Public Sector Enterprise (PSE) reform was initiated through an ADB Technical Assistance and agreed target transformations were specified in the Private Sector Development Program (PSDP). Finally, the other main component of the PSRP was reform of the regime for foreign direct investment (FDI) through establishment of a transparent and predictable system implemented at the state and national levels. As with measures to reform the public enterprise sector, efforts to further improve the environment for FDI were incorporated into the PSDP. These are discussed below.

Private Sector Development

THE PRIVATE SECTOR DEVELOPMENT PROGRAM

93. With the closeout of the PSRP at the end of 1999, the intention was to maintain the reform effort through implementation of the Private Sector Development Program (PSDP) loan. The PSDP was designed to shift the focus to private sector development, but was also intended to secure the achievements made under the Private Sector Reform Program (PSRP). Particularly important was the intent to lock in the existing reforms before the release of the bump-up funds in FY2002 and FY2003. However, the program was delayed. A Basic Social Service (BSS) sector loan was accorded priority by the ADB and resulted in confusion. Neither loan was approved by the FSM Congress until late in 2000. Subsequent approval and authorizing legislation at the state level was also slow in coming, and not attained until a further year later. While the intention had been to follow the PSRP with the PSDP during 2000, actually implementation did not start until 2003. By this time the FSM was into the bump-up period, the Compact renegotiations were

well under way diverting attention from further reform, and momentum was lost. The loan program was finally closed-out by the ADB in February 2007.

94. The PSDP was structured in two parts: a project and a program loan. The project loan contained a series of activities designed to improve the environment and capacity for private sector development, including improvements to the legal and regulatory environment; increased access to, and security of, land for economic use; increased access to finance for small business; and improvements to business and entrepreneurial skills. The policy loan was tranched in two parts. Compliance with a series of policy reforms opened the door for the second tranche draw down. Only the national and Kosrae state governments were deemed compliant by the ADB and qualified for second tranche draw down. The policy measures required to be met in each state included:

- Maintenance of medium-term fiscal balance (maintaining current expenditures within pre-bump-up revenue levels),
- Maintenance of government payroll levels within specified targets,
- Sterilization of bump-up funds,
- Sound external debt management (national government only),
- Foreign investment laws amended and regulations improved,
- Long-term lease and mortgage legislation enacted (state governments only), and
- Public Sector Enterprise reform and at least one entity transformed.

95. While official review of the PSDP policy matrix indicates that all governments passed the requirement to maintain medium term fiscal balance in FY2003 and FY2004, only Yap achieved this requirement. All other governments either failed to maintain medium-term balance in one or both of FY2003 and FY2004. All governments, except Kosrae, were below their payroll targets as of April FY2006, and the bump-up funds were effectively sterilized in FY2002 and FY2003, fulfilling the U.S. requirement that the FSM contribute $30 million to the Compact Trust Fund. The FSM has maintained a sound external debt profile. Discussion of the foreign investment regime, long-term leasing, and PSE reforms are based on a report prepared for the ADB by Rick Caldwell ("Legislation for Private Sector Development", November 2005), and a loan close-out report prepared by the FSM.

96. ***Foreign Investment Reform:*** Until the late 1990s, control of foreign investment in the FSM was regulated by the national government and based on an outdated law enacted during the Trust Territory days. The states indicated concern about slow processing, insufficient sensitivity to local concerns, and usurpation of power by the national government. Except for a few sectors of undisputed national interest, there was general agreement at all levels in the FSM that decentralizing the control of foreign investment to the states was a good idea. While the states sought decentralization, development experts and foreign investors were concerned about the restrictiveness and lack of transparency in the existing law. The Foreign Investment Advisory Service (FIAS), a joint facility of the

International Finance Corporation and the World Bank, was requested to do a review. FIAS proposed a “stoplight system” of red, amber, and green lists, which was incorporated as a loan covenant of the PSRP. The new foreign direct investment (FDI) regime was subsequently adopted by the national government in 1997 and three of the states followed soon after. Pohnpei already had a foreign investment regime of its own design and did not wish to adopt the same approach as the other FSM governments.

97. The new FDI regime had four goals: (1) decentralization, (2) uniformity of structure, (3) making the rules less restrictive, and (4) making the rules more transparent. The new regime achieved decentralization, but at the cost of the need to apply for more than one permit if an investor wished to operate in more than one state. With Pohnpei state maintaining a Foreign Investment Board approach to FDI, the objective of implementing a uniform structure to FDI was not achievable, although the structure of the laws in the other four governments remained similar. While there was some improvement in the areas of restrictiveness and transparency, these goals were mostly subverted by changes that each government made to the model FDI legislation.

98. At the request of the national government in September 1999, FIAS was requested to review the changes in the laws and regulations implemented by the five governments during the PSRP and propose changes that would help the FSM achieve the original objectives of the reforms. The recommendations proposed by FIAS became the requirements for each government to implement to qualify for second tranche release of the PSDP funds.

99. It is important to bear in mind that the new FDI regime in the FSM is highly dependant upon regulations. In each government, the statute sets forth a framework for regulation, leaving much of the detail to be fleshed out in regulations. Since regulations implement statutes, amendment of regulations is generally required after any significant statutory amendment, thus creating a two-step process with all its timing implications.

100. Reviewing the progress of each government in turn, the national government was required to make amendments to the existing statutes and implement regulations compliant with the FIAS review. The revised bills and regulations were signed into law by the end of 2005. In Chuuk revisions to the law were proposed and new regulations prepared. However, despite no apparent opposition to the proposals no progress was made. In Kosrae the proposed changes to the law and regulations were both enacted by the legislature and signed into law. In Pohnpei the general aversion to FDI resulted in the state remaining out of compliance with the PSDP matrix. In fact, recent legislation passed by the state legislator in December 2006 prohibits FDI in many service sectors which compete with local interests. While tourist support services are reserved for local business, larger hotels greater than 12 rooms remain open to foreign investment. As a consequence of these changes one dive operation went out of business and currently Pohnpei state has no operators in this sub-sector. In Yap state the changes recommended were enacted by the end of 2005. Thus, of the five governments, national, Kosrae, and Yap implemented the nec-

essary reforms, while Chuuk and Pohnpei remain non-compliant where the environment for foreign investment remains adverse.

101. ***Land Leasing and Mortgage Reform***: The FSM constitution prohibits ownership of land by noncitizens. The constitutions of two states—Kosrae and Pohnpei—prohibit ownership even by citizens from other states in the FSM. The availability of land for development and as collateral for financing is critical if there is to be significant private sector development. With this background, the ADB sponsored TA in 1999 to develop the necessary legal framework for a system of long-term land leasing and mortgage reform. The result was a report prepared by Rick Caldwell entitled *Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging*. The report became the basis for the second tranche requirement that "the legislative branches of the States shall have passed legislation improving the legal environment for long term leasing of land and for encouraging mortgage-secured commercial lending." Unlike the FDI case, the proposed reforms only required legislative action, avoiding the need for an accompanying set of regulations. Land issues clearly fall under the domain of the state governments, which implies that no action was required of the national government.

102. Before commencement of the PSDP Chuuk was the only state to have adopted legislation in the land area. However, there were numerous shortcomings of the legislation and, although there was no opposition to the proposed changes to bring the laws into compliance, these were not implemented. Like the proposed changes to the FDI regime, a lack of inertia was reported as being the major fault. In Kosrae the state adopted a proactive position and passed the required amendments bringing the state into compliance with the PSDP. In Pohnpei proposed changes to the existing land legislation were considered, but once it was apparent that the state would not qualify for the second tranche draw down, the state lost interest. In the case of Yap, while the state is generally reform-minded the interaction between land and culture comes to the forefront. While the Executive branch supported the land reform initiatives, the two bills have been held up at the legislature, resulting in the state failing to qualify for second tranche draw down.

103. ***Public Enterprise Reform***: While the PSRP entailed reform and restructuring of the public sector, there was little emphasis on PSE transformation. Much of the groundwork for PSE reform in the FSM came from a subsequent ADB TA entitled *Privatization of Public Enterprises and Corporate Governance Reform*. The final report prepared in 2001—commonly called the "Aries Report"—identifies a variety of activities that can constitute PSE reform, including liquidation, divestiture, corporatization, commercialization, governance reform, and outsourcing of goods or services. However, while the Aries Report analyzed the FSM PSE sector, proposed an institutional structure for reform, and identified suitable candidates for transformation, no reforms took place. The findings and recommendations of the TA were to form part of the PSD reform requirements, which included (1) preparation of master plans for public enterprise reform for submission to each government and (2) transformation of at least one enterprise.

104. Before discussing the progress attained during the PSDP, it is well to recap some of the important features of the PSE sector. The FSM Strategic Development Plan identifies 22 major PSEs operating in the financial sector, utilities, fisheries, and a miscellaneous category. In the FY1997–FY2001 period, the sector employed an average 990 people (6 percent of the labor force) and contributed $14 million to GDP (7 percent.) Overall the sector made an annual net loss of $0.9 million and required annual subsidies of $4.9 million to support operations. Salaries are 2.5 times the private sector average. From FY1995 through FY2004 the capital base of the sector fell from $222 million to $186 million, almost of all it representing accumulated losses of the fisheries sector.

105. The first requirement of the PSDP was the transmission of PSE master plans to each government. However, while this objective was completed, not one master plan has been institutionalized or acts as an active framework guiding PSE management or transformation. Regarding actual PSE reform, a qualifying transformation was regarded as one that reduced government costs, improved service delivery, or avoided crowding out the private sector. In the case of the national government the capital water system was transferred from a national department to the Pohnpei Utilities Corporation. This was accepted as a qualifying transformation. In Chuuk no transformation took place that enabled the state to qualify. In Kosrae the state government outsourced the operation of the hospital food service, which was deemed as a qualifying transformation. In Pohnpei, due to financial considerations the state was forced to sell three fishing vessels to a private company. Although there was no evidence that the transformation was intended to satisfy the PSDP condition, it was accorded a compliant transformation. In Yap the state transferred the television service from a state owned department to FSM Telecom and was deemed compliant.

106. While in four out of five cases the governments of the FSM were deemed to be in compliance with the PSD requirements, two involved transference of an enterprise to a different level of government, one took place by default, and one was largely insignificant. Not one of the transformed enterprises was represented in the 22 major PSEs identified in the Strategic Development Plan. Clearly, while perhaps qualifying by the letter of the law, the PSDP transformations did not fulfill the spirit of reducing the size or role of government in the economy. On the positive side Pohnpei state has subsequently transformed two of its loss-making fisheries enterprises since the close-out of the PSDP. The Caroline Fisheries Corporation is now under 60 percent foreign ownership with the remaining 40 percent held by the state. While the assets of the Pohnpei Fisheries Corporation remain under state ownership, it has now been leased to a private foreign investor. Finally, the Micronesian Longline Fisheries Corporation, a national government enterprise, has now filed for bankruptcy and is under liquidation.

107. Table 9 proves a summary table of the current position of each state in implementing the PSDP policy reforms (this does not equate with compliance with the ADB loan covenants). An average score, based on a possible score of 6, is provided on the basis of whether each currently government fulfills the respective policy reforms. The table

Table 9 Compliance with PSDP policy reform conditions and overall score (max. 6)

	Chuuk	Kosrae	Pohnpei	Yap	National
Medium term fiscal balance	0	0	0	1	0
Maintenance of government payroll	1	0	1	1	1
Sterilization of “bump-up” funds	1	1	1	1	1
Sound external debt management					1
Foreign investment regime	0	1	0	1	1
Long-term lease and mortgage legislation	0	1	0	0	
PSE reform	0	0	1	0	0
Score	**2**	**3**	**3**	**4**	**4**

indicates a mixed level of success and compliance. Yap and the national government scored the highest level, fulfilling a majority of the reforms. In the case of Yap the state failed to fulfill the land reform component and like most other states failed to complete any serious public enterprise transformation. The national government complied with four of the conditions, but during FY2002 and FY2003 ran medium term fiscal deficits and failed to achieve any substantial transformation of a public enterprise. Kosrae fulfilled three of the conditions, and was more favorable to enact policies that supported private sector initiative, but lacked fiscal discipline or made any serious efforts to reform its public enterprises. In fact through the creation of the Micronesian Petroleum Corporation, the state extended the boundaries of the public sector. While Pohnpei has generally maintained fiscal discipline, it surprisingly failed to meet the medium-term fiscal balance requirement, and the environment for private sector development is inward-looking. Only recently the reform of two of its PSEs has enabled the state to achieve a higher score. Chuuk produced the least satisfactory result reflecting weak fiscal management and a general lack of administrative capacity to enact any reforms rather than any policy decision not to encourage the private sector.

Tax Reform

108. The need to reform the FSM tax regime has been long recognized. While the existing system served the needs of the nation reasonably well during the early days of nationhood, it does not provide a strong foundation for an elastic source of revenue without distorting economic incentives. While the design of the PSRP took into account the long-term need for tax-reform, it was felt in the short to medium term that efforts should be directed to improvements in administration and reform of known weaknesses of the existing system. It was understood that radical reform of the tax system should be deferred until after the PSRP was complete.

109. As the Compact renegotiations neared completion it became clear that the new structure of the amended Compact would entail significant adjustments, both in the short term and during the 20-year horizon. The new sector grant approach resulted in a system that provided sufficient funding to maintain the operations of education and health and

selected sectors, but failed to support the ongoing needs of many government functions. In the near term, the United States permitted the FSM to utilize the capacity building sector grant for non-conforming purposes, provided it was agreed that these would be transitioned out over a five-year period. In the long term, a reduction in the resources of the amended Compact was programmed through an annual decrement of $0.8 million, and lack of full indexation of the transfers. Thus both the short and long-term reduction in funding required that the FSM consider measures to increase revenue effort if the burden of adjustment was not to fall entirely on expenditure compression.

110. In 2002 a nationwide tax and revenue symposium was held to raise the awareness of the problems and encourage steps that would result in revenue and tax reform. The symposium passed two important resolutions. First, it recommended the introduction of a comprehensive tax reform program including the introduction of a broad based consumption tax (value-added tax plus excises) and, subsequently, a simple net profits tax. The consumption tax would be enacted at the state level, replacing the existing national gross revenue, and state sales taxes. Second, the symposium recommended the establishment of a unified tax administration to implement the new regime and collect taxes on behalf of both layers of government.

111. In March 2004 the FSM convened the Third FSM Economic Summit. Participants were presented with varying scenarios that ranged from a dismal one, where the FSM failed to generate economic growth and many Micronesians were forced to migrate due to lack of opportunities, to a Sustained Growth Strategy (SGS). It was recognized that attainment of the SGS would entail the need for additional domestic resource mobilization, not only for adjustment to the conditions of the amended Compact but also to support public investment in needed infrastructure. A modern tax regime was required that supported the adopted outward-orientated growth strategy and encouraged private sector investment.

112. During the remainder of 2004, with support from the ADB and Pacific Finance Technical Assistance Center (PFTAC), the design and structure of a modern tax regime appropriate to the FSM was fleshed out. In Chuuk in September 2004, a preliminary working group with delegates from both national and state governments met and organized a task force with representation from the various stakeholders, especially the private sector, to provide a comprehensive approach to the issue of tax reform. In January 2005, the Tax Reform Task Force (TRTF) was formally organized and created by the FSM president. The TRTF would be chaired by the vice-president, with the FSM Customs and Tax Administration forming the secretariat. Membership on the task force included the FSM secretary of finance, representatives from the private sector, one from each state, and two members from the FSM Congress. The objectives of the TRTF were:

- To examine different options for reform of the FSM tax system in order to meet expected reductions in revenues and to support the long-term sustained economic development of the nation.

- To prepare a tax reform proposal to present to the leadership of the FSM and the FSM Congress for consideration and enactment at the earliest possible time.
- To assist in education, holding of seminars and working groups to increase public awareness about the fiscal implications of the amended Compact, and the need to generate more local revenue, for tax reform, and to strengthen tax administration.

113. In June 2005 the TRTF submitted to the president its final recommendations, which the president approved in December. The key recommendations include:

- The establishment of a new modern independent tax collection authority with operations nationwide.

- Introduction of a new Net Profits Tax (NPT) that allows for deductions of business expenses. The NPT will replace the existing Gross Revenue Tax (GRT). Introduction of a new Value Added Tax to replace import duties and state sales taxes.

114. In September 2005 the reform proposal was put to the Economic Policy Implementation Council (EPIC) and was adopted by resolution (similar resolutions had been adopted on previous occasions.) Congress similarly adopted the reform proposal (for the first time) in September and requested the President to establish an executive steering committee (ESC). The ESC has governance responsibility for implementing tax reform in the FSM. It is chaired by the Vice President and has representatives from each State and the private sector. Laws were drafted with the support of the IMF for the creation of a Unified Revenue Authority, a new Revenue Administration Act, and new VAT and NPT laws. At its inaugural meeting in June of 2006, the ESC adopted the creation of a Technical Working Group (TWG) to be responsible for determining the core tax and administrative policy for the ESC to approve. The Group is chaired by the Secretary of Finance and Administration and has representatives from the FSM Customs and Tax Administration office (CTA), FSM Department of Justice, Pohnpei State Department of Finance, and the private sector.

115. In April of 2007 the ESC convened again and reaffirmed its commitment to the tax reform initiative. During the same meeting, the ESC also endorsed the high level implementation plan for the tax reform and requested the states to get up state implementation teams (SITs) to help accelerate implementation of the tax reforms at the state level. The Technical Working Group was tasked with preparing a detailed implementation plan and preparing a tax reform package for submission to each of the FSM states. In July the first state level meetings were held. Given the low level of administrative capacity in the FSM, donor support is critical. It must be envisaged that a resident team of tax experts will be required for several years, if successful implementation is to be achieved.

116. The Tax Reform Unit was created in late 2007 to manage the reform process. The TRU is staffed by a project manager and an AusAid Tax Adviser. The project manager commenced work in the FSM in early April 2008 for a period of two years. The TRU

has been allocated a budget by Congress. Based on the high level implementation plan endorsed by ESC in April 2007, a detailed operational plan for implementing the proposed tax reforms was developed with the assistance of PFTAC in December 2007, The plan schedules activities from 2007 to 2010 and comprises 5 sub-plans:

- Project Management and Governance Program
- Law, Policy and Estimates Program
- Tax Administration and Tax Change Program
- Business & Community Program; and
- VAT registration Program.

117. The TRU has been working closely with the established governance groups (the TWG, the SITs and the ESC) to progress the reform measures in accordance with the implementation plan. A TWG meeting took place in April 2008 to review the legal and policy issues identified during the July 2007 SIT meetings. Following on from the April 2008 meeting, SIT meetings were held in each of the states in May and June to review the known issues with the draft legislation and to identify any new issues. While in the states the TRU took the opportunity to meet with the State Leadership and to provide a tax reform overview to revenue staff. An ESC meeting was held in July, during which the TRU presented its quarterly status report for the period 1 April to 30 June 2008. The ESC members reiterated their support for the tax reform measures at this meeting.

118. The TRU will continue to ensure that governance meetings take place regularly. The TRU intends to convene SIT meetings approximately every two months. This of course does not prevent the SIT's meeting more regularly at their initiative. TWG meetings will be convened after the SIT meetings (as necessary) and ESC meetings will occur at least quarterly.

119. Finalization and transmission of the reform legislation is a key milestone in the Law, Policy and Estimates sub-plan. While it was originally planned to finalize and transmit the legislation in July 2008, this did not occur because several significant legal issues were identified by the States during the 2008 SIT meetings. In addition there are a number of outstanding policy issues requiring an ESC decision. Despite these setbacks, it is still planned to have the legislation passed by December 2008 in accordance with the implementation plan.

120. The TRU has been working pro-actively to resolve all outstanding legal and policy issues. A two day meeting with representatives from the State and National Attorney General offices was convened in mid July to progress the identification and resolution of the legal issues. Unfortunately, an IMF legal mission, which was organized to coincide with this meeting to enable the author of the legislation to participate in the discussions did not materialize. A second and final meeting with representatives from the Attorney Generals offices will be held after mid August, at which time the Attorneys General are

expected to have finalized their position papers. It is hoped that the IMF legal mission can be re-scheduled to correspond with this meeting.

121. The TRU is preparing briefing papers, including recommendations on the outstanding policy issues. These briefing papers will be presented at the next ESC which will take place following the final meeting with the Attorneys General. Early in the fourth quarter of 2008, the TRU intends to conduct visits with each State with the express purpose of engaging with members of the State Legislatures and the State Leadership prior to the transmission of the legislation. The Vice President, who is also Chairman of the ESC, plans to participate in these visits to champion the reforms.

122. Other key pieces of work undertaken in the second quarter of 2008 included the finalization of the Tax Reform Communication Strategy, the commissioning of a consultant to develop a tax reform website and the identification of an IT expert to determine the technical specifications required for the planned new computer system (hardware and software) and to test the market for suitable products. The IT work will be funded by PFTAC.

123. Clearly progress with the tax reform initiative has been slow, but work is now progressing. Unfortunately, implementation of the tax reform initiative will be too late to assist in transitioning out the use of the capacity building grant from non-conforming purposes in Chuuk and Kosrae states. Adjustment will need to be made through painful expenditures cuts and reductions in payroll. However, the need for tax reform remains to assist with adjustment to the annual decrement over the remainder of the amended Compact period, and to support the private sector through the adoption of a broad based, modern, and non-distortionary tax system.

Outlook

Adjustment to the Amended Compact

124. After successful completion of the Compact renegotiations with the United States, the FSM was left with a set of fiscal adjustments. First, the amended Compact entailed an 8 percent decline in funding from $83 million to $76 million. Second, the switch from a general budgetary support to a sector grant approach meant that there was a shortage of domestic revenues to fund non-Compact sector operations, such as administration, law and order, public works, transportation, etc. In the interim, the United States agreed that the FSM could use the capacity building sector grant to fund operational activities listed under the grant, provided that the FSM agreed to phase out these activities over a 5-year period. Third, those activities that were not listed under the capacity building grant required immediate adjustment. Fourth, the United States imposed the requirement that 30 percent of Compact resources be devoted to infrastructure. And finally, the loss of the Compact I energy grant meant that in certain states utility corporations were forced to raise prices to cover costs that had previously been subsidized.

Table 10 Capacity building sector transition and Compact fiscal adjustment

	FY07	FY08	FY09	Domestic Revenues	Annual Compression Required /1	3 Year Compression Required
Chuuk	884	884	884	6,988	11.2%	27.5%
Kosrae	92	462	462	2,124	17.9%	32.3%
Pohnpei	329	329	329	12,806	2.5%	7.1%
Yap	449	449	449	5,672	7.3%	19.2%
National				27,112		
FSM	1,753	2,123	2,123	54,703	3.7%	9.9%

Note /1 For Kosrae compression ratio refers to FY08 and FY09 levels

125. The first two years (FY2005 and FY2006) of the phase out of the use of the capacity building grant from non-conforming activities were met through switching the source of funding of national government operations to domestic revenues, and funding the College of Micronesia out of the education sector Compact grant. The four state governments were thus largely spared the need for adjustment, although the 30 percent infrastructure requirement, and lack of Compact funding for such activities as public works still required adjustment, particular in Kosrae. Table 10 indicates the required adjustments during the remaining three years of the capacity building adjustment period (FY2007 through FY2009), which fell entirely on the state governments. In Pohnpei the annual adjustment of 3 percent was quite small and has been easily absorbed. In Yap the adjustment has also been completed through funding the required activities out of the state's investment reserves. While Yap speedily resolved the problem, the long-run sustainability of the decision to draw down on reserves to fund operational activities is open to question, and certainly raises the issue of the optimal use of the state's hard earned savings. In Chuuk, the capacity building transition issue was not addressed in a timely manner and the state met the FY2007 phase out requirement through deficit spending. In Kosrae, the state opted to defer transition until the last two years of the five-year period, and coupled with the failure to adjust to the other requirements of the amended Compact, placed the state in an unenviable position as the FY2008 budget neared. The next section discusses in more detail the situation in Kosrae and Chuuk and the significant adjustment plans that have, for the most part, been implemented by the two states.

Adjustments in Kosrae and Chuuk

Kosrae

126. The imminent and dire implications of a lack of response to the need for fiscal adjustment that was looming in advance of FY2008 compelled the Kosrae leadership to confront the problem. At a leadership conference in May 2007 an adjustment package was worked out not only in response to the capacity building transition, but also to rectify past deficit spending. The new Administration found itself in an untenable fiscal position; however, with reform measures adopted, the fiscal threat was effectively addressed. The adopted measures included \$1.9 million in adjustments through: (i) expenditure reduc-

tion, (ii) enhanced revenue effort, and (iii) measures to mitigate the impact of the adjustment. Expenditure compression focused on the elimination of 98 positions from the FY2008 budget—64 positions to be eliminated completely and the removal of 34 vacant positions, with a total planned cost savings of $719,000. Expenditure compression included a further $254,000 in a 5 percent across the board pay cut, and $120,000 in non-payroll cost reductions. Revenue measures included hikes in tax rates to raise a total of $511,000. The total impact of both the revenue and expenditure measures totaled $1,606,000 with $293,000 remaining to be accomplished in the FY2009 budget submission. Measures to mitigate the impact of the RIF include a one year salary payout, with proposed U.S. support by way of Compact sector grant funding. This mitigation measure was augmented in-kind by grant assistance channeled through the National Government, but sourced from the People's Republic of China.

127. Looking forward to FY2009, Kosrae State has not completely made the adjustment to the new terms of the amended Compact. The State is yet to achieve a final reduction of $293,000, which is currently programmed under the Capacity Building sector grant for non-conforming purposes. On the other hand, a greater number of position reductions than the commitment of 98 were accomplished (115). Still the Government remains in a tight and potentially precarious fiscal position as there are no general fund reserves to respond to emergencies. Neither is the FY2009 budget request fully compliant with JEMCO pronounced requirements that all planned uses of the two smallest grants—private sector and environment—be planned in accordance with a comprehensive national plan. By inference, planned uses cannot simply be a continuation of funding for the same recurrent salary positions formerly funded under non-restrictive sector grant interpretations that were allowed to prevail during the initial five years under the amended Compact. These two grant requests for the FY2009 budget amount to $730,259 for private sector and $244,581 for environment and represent together 11 percent of the State's Compact sector fund allocation. In the absence of a resolution prior to the outset of FY2009, the State will again be faced with an adjustment problem of immense proportion. Local revenue sources, even with the tax measures implemented in FY2008, are projected optimistically at just $2,431,616; so there is no capacity to adjust to any significant award reductions below the requested amounts.

Chuuk

128. While Kosrae State was able to make a timely and well-sized adjustment in response to the challenge of the fiscal adjustment, Chuuk State was considerably slower in its response. The State initially executed a series of MOU's with the national government committing the State, in principle, to the achievement of financial and structural reforms. As of the first quarter of FY2008, Chuuk had an accumulated unreserved general fund deficit in excess of $27 million and an estimated outstanding debt well in excess of that same amount. In contrast to the adjustment measures adopted by Kosrae, those proposed in the Chuuk MOU's lack credibility and were not designed in a targeted manner to seriously address the problems at hand. By November of 2007, facing a threatened

cessation in some components of annual Compact sector grant funding, Chuuk State leaders convened a conference to adopt more comprehensive adjustment measures.

129. The adjustment program in Chuuk is similar in nature, but not in magnitude, to that of Kosrae. The target was set at $3.47 million in annual adjustment through both expenditure compression and revenue enhancements. This much greater amount in adjustment reflects a need to close a persistent deficit ($1.97 million) and create a persistent surplus ($1.5 million) in order to credibly and consistently address its problem of outstanding debt. The commitment to personnel reductions by the leadership was for 356 positions, although ultimately over 375 positions were identified for the RIF program with a one-year payment financed by Compact sector grant assistance. An additional $222,128 was identified as non-payroll general fund expenditure cuts. Revenue raising measures amounting to $600,000 were also identified.

130. As of mid-FY2008 the adjustment measures were being implemented; however, some terms of the State's MOU commitments to the national government are not being honored. Worse, the financial management coherence of the State is put to question by the firing of the former Director of Finance and Administration. Even during that individual's tenure through July 2008, the State was not depositing excess general fund revenues into the required Stabilization Fund. As such, payments against prior year debts, although being made to some extent, are not being implemented in the manner to which the State committed to both the national government and the US government through implementing arrangements for the RIF assistance. As a result, funding for the two smaller Compact grants, private sector and environment, may be suspended for the final two months of FY2008. The national government may impose further restrictive fiscal measures as well. In the end, the State is ending FY2008 in a financial position not significantly improved despite the reduction-in-force of over 375 employees.

131. The prospects for FY2009 remain clouded. In addition to the non-compliance with financial management and debt repayment measures, the State's budget request mirrors that of the other State's. The State has requested $1,228,682 under the private sector grant and $680,789 under the environment sector grant. This represents over 6 percent of the total Compact request and is large relative to the State's optimistic general fund forecast of $6,881,058.

Long-Term Perspectives

132. The 3rd FSM Economic Summit was held in Palikir, Pohnpei, from March 29-April 2, 2004. The Summit was presented with three economic scenarios that the FSM might experience over the next 20-year period of Compact support: a dismal scenario, a medium-growth scenario and a sustained growth scenario. While noting that the FSM might face a truly "dismal" scenario if the country's leadership failed to make needed economic adjustments to offset the drag on economic activity resulting from the structure of Compact assistance, the discussion focused primarily on "moderate growth" and the

"sustained growth" scenario. The Summit adopted a six-part strategy for transition and accelerated growth:

- Macroeconomic Stability
- Good Governance: Improving Effectiveness and Efficiency of Government
- Developing an Outward-Oriented, Private Sector-Led Economy
- Investing in Human Resource Development
- Investing in Infrastructure
- Long-Term Sustainability

133. The FSM Strategic Development Plan (SDP) examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns (see Figure 17.) Under the sustained growth scenario economic growth is held back initially as the economy adjusts to the structure of the amended Compact. However, as the benefits of the sustained growth strategy take hold, the economy is projected to accelerate and attain an annual average rate of 2.6 percent over the whole period. On the other hand under the dismal scenario economic growth is weak and the economy is only projected to achieve 0.1 percent over the period.

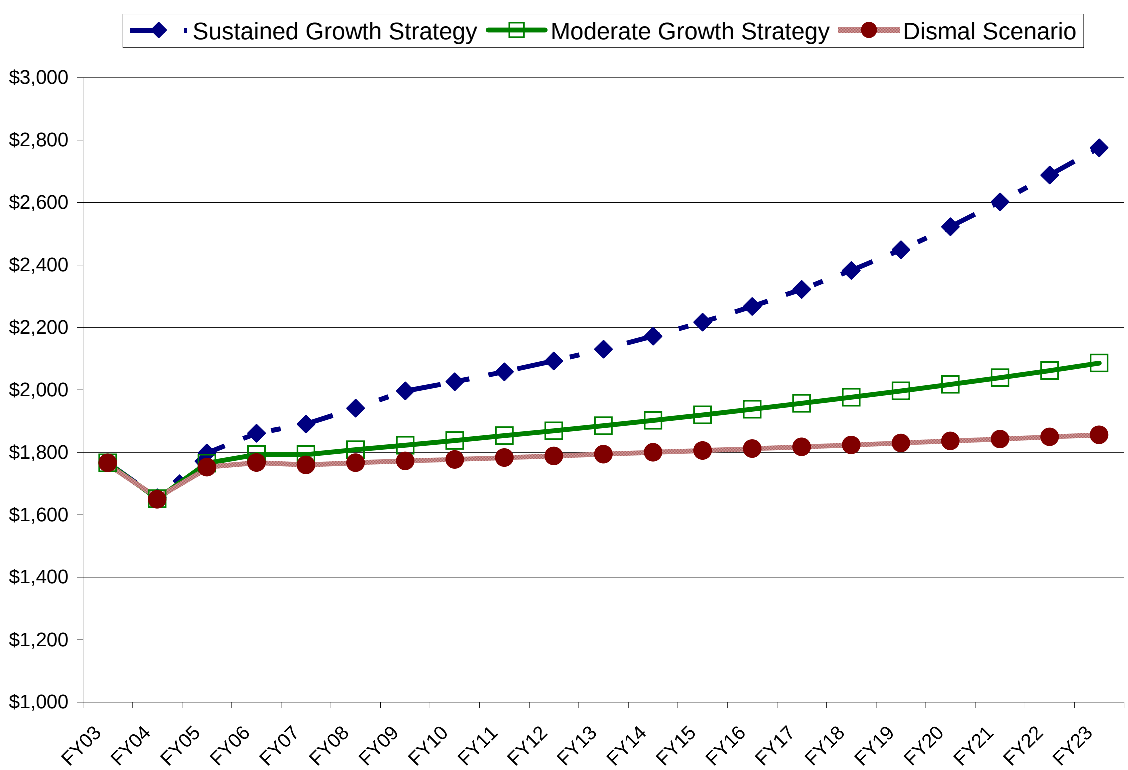


Figure 17 Alternative growth scenarios, GDP per capita, $s 1998 prices

134. Figure 18 makes a comparison of the projected dismal scenario with the actual performance since FY2003.. While the model on which the projections of the SDP were based overestimated the impact of the amended Compact on the FSM economy in FY2004, the projection for the dismal scenario significantly out performs the actual growth attained. While previous policy recommendations have been aimed at how to accelerate growth and development, and to move the FSM off the dismal growth path, current initiative must now be focused on completing the fiscal adjustment to the amended Compact in an orderly fashion while minimizing the negative consequences for economic growth. Future initiatives may return to the objectives of the 3rd Economic Summit and national Strategic Development Plan, but current efforts must be directed towards implementing the tax reform agenda, completing the adjustment to the amended Compact, transitioning the capacity building sector grant, and preventing financial collapse in Chuuk state. With these objectives successfully completed, the FSM can once again return to the debate on how to achieve accelerated economic growth, and seek support from the donor community.

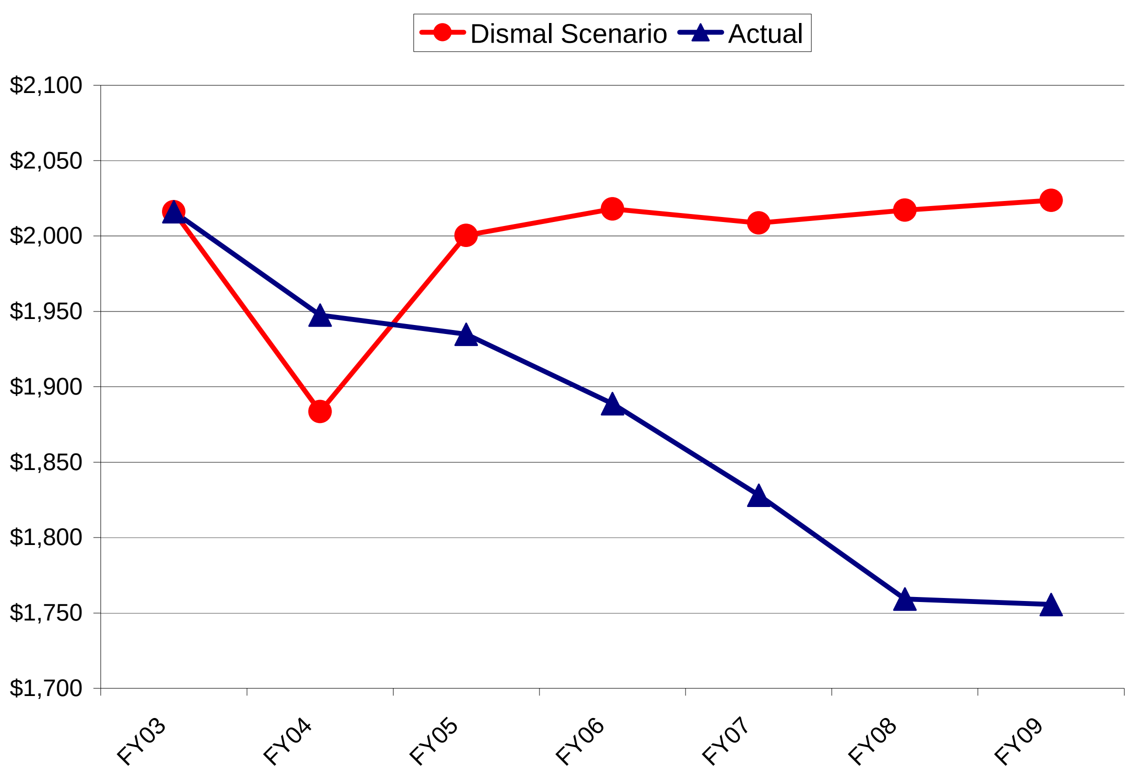


Figure 18 Comparison of the Third Summit dismal scenario with performance—GDP per capita, $s 1998 prices