Second Five-Year Review of the Compact of Free Association, as Amended, Between the Government of the United States and the Federated States of Micronesia

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
Amended Compact	—	Compact of Free Association Between the FSM and United States, as amended (entered into force May 01, 2004)
Amended Compact Act	–	Compact of Free Association Amendments Act of 2003 (P.L. 108-188)
AusAID	—	Australian Agency for International Development
c.i.f.	—	cost, insurance, and freight
COFA	—	Compact of Free Association
COLA	—	cost-of-living adjustment
Compact	—	Compact of Free Association Between the FSM and United States (entered into force November 2, 1986)
CPI	—	consumer price index
CTF	—	Compact Trust Fund
ESC	—	executive steering committee
FAA	—	Federal Aviation Administration
FDI	—	foreign direct investment
FIAS	—	Foreign Investment Advisory Service
FMIS	—	financial management information system
f.o.b.	—	free on board
FPA	—	Fiscal Procedures Agreement
FSM	—	Federated States of Micronesia
FY	—	fiscal year
GAO	—	U.S. Government Accountability Office
GDP	—	gross domestic product
GNDI	—	gross national disposable income
GRT	—	gross-receipts tax
IDF	—	investment development fund
IMF	—	International Monetary Fund
JEMCO	—	Joint Economic Management Committee
LTFF	—	long-term fiscal framework
OIA	—	Office of Insular Affairs
PEFA	—	Public Expenditure and Financial Accountability
PFM	—	public financial management
PFTAC	—	Pacific Financial Technical Assistance Center
PMU	—	project management unit
PNA	—	Parties to the Nauru Agreement
PSDP	—	Private Sector Development Program
PSE	—	public-sector enterprise
PSRP	—	Public Sector Reform Program

RAA	—	Revenue Administration Act
RIF	—	reduction in force
SAFER	—	Sustainability Adjustment for Enhanced Reliability
SDP	—	Strategic Development Plan
SEG	—	Supplemental Education Grant
SOE	—	state-owned enterprise
TWG	—	technical working group
URA	—	Unified Revenue Authority
U.S.	—	United States
VAT	—	value-added tax

NOTE: The FSM government's fiscal year (FY) ends on September 30.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

Executive Summary

A. Purpose of the Report

1. This report is submitted pursuant to section 104(h) of Public Law 108-188, which calls for an annual report to Congress as well as a review of the terms of the Compact of Free Association, as amended, between the Government of the United States (U.S.) and the Government of the Federated States of Micronesia (FSM) (Amended Compact), following the fifth, 10th and 15th anniversaries of its enactment. The Amended Compact Act (Public Law 108-188) was enacted on December 17, 2003, and the review covers the 10-year time period from FY2004-FY2013.[1]

2. As further specified by law, this report reviews the overall nature and development of the U.S.-FSM relationship, including: (A) general social, political, and economic conditions, including estimates of economic growth, per capita income, and migration rates; (B) the use and effectiveness of U.S. 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, non-U.S. contributions to the trust funds, and the level of private investment; and (E) recommendations on ways to increase the effectiveness of U.S. 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.

3. The review undertaken for this report was mandated to be conducted in a manner that considers the operating requirements of the FSM and the nation's progress – including that of the four constitutive states, Pohnpei, Yap, Chuuk, and Kosrae – in meeting the development objectives set forth in its official development plan, the FSM Strategic Development Plan (SDP). The preparation of this report included an offer of outreach to the Government of the FSM to put forward its concerns, issues, and potential recommendations.

1. Economic Developments

4. ***Economic Growth:*** During the review period covered by the 10-year review (FY2004-FY2013) the FSM economy declined by 3.4 percent, or by an annual average of 0.3 percent. During the first five years of the period, economic performance was weak in the FSM, due to difficult adjustments to the Amended Compact. However, the following four years saw improvement, in large part resulting from the strong demand for infrastructure funded by the U.S. Federal Aviation Administration (FAA) and Amended Compact infrastructure-sector grants. However, in FY2013 the economy dipped back into recession and contracted by 3.4 percent, reflecting reduction in infrastructure demand, as FAA projects were completed and planning and management issues impeded the use of the Amended Compact infrastructure-sector grant.

5. ***Population, Migration, Employment, Inflation, and Wages:*** The FSM's population has declined by an average of 0.4 percent per annum between the census years of 2000 and 2010.

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1 "Compact" refers to the original 1986 Compact, while "Amended Compact", refers to the 2003 Compact.

While the natural rate of population growth has declined, this mainly reflects significant migration to the United States and its territories. Between 2004 and 2011, the rate of migration was 1.6 percent per annum, with an estimated departure of 15,500 people. There are significant migrant communities now in Guam, Hawaii, Oregon, and other states. During the review period, employment has fallen by 1.6 percent per annum, and the economy has been unable to generate sufficient jobs to meet the demands of a young and growing labor market. Employment in the private sector fell by 0.4 percent, while that in the public sector fell by 2.9 percent. Inflation averaged 4.4 percent during the period under review—higher than the comparable level in the U.S. of 2.4 percent. This was due to the higher weight of food and fuel in the FSM consumption basket. Wages grew by an annual average of 2 percent, indicating that real standard of living has fallen at an annual rate of 2.4 percent.

6. ***Fiscal Performance and External Debt:*** At the start of the Amended Compact (FY2004), the FSM recorded a significant fiscal deficit of 15 percent of GDP, reflecting difficulties in adjusting to the sector grant requirements under the Amended Compact. However, with reduction-in-force (RIF) programs implemented in two of the FSM states and fiscal restructuring by all four states, fiscal balance at the FSM level was restored by FY2009—a significant achievement. With the large and recent increase in fishing fee revenues, a sizeable fiscal surplus (2.9 percent of GDP) has been achieved. However, this favorable outcome masks significant differences between the FSM national and state governments. The four FSM state governments, where service delivery occurs, have been constrained by the declining real value of Amended Compact grants, due to the annual decrement and two-thirds inflation indexation. The national government has benefited from significantly increased revenues from fishing fees and, to a lesser extent, the tax domicile the FSM offers to certain segments of the Japanese corporate market. The national government realized a surplus of $11.7 million, while most states recorded small deficits, amounting to $2.1 million. External debt, at 28 percent of GDP, has maintained very low levels, and debt service, at 8.1 percent of national government domestic revenues, remains well within the capacity of the national government.

2. The Policy, Regulatory, and Institutional Environment

7. ***Fiscal Policy:*** At the start of the period under review, the FSM was faced with the issue of restructuring departmental expenditures to meet the new structure of U.S. grant assistance provided under the Amended Compact. After a period of adjustment and execution of RIFs in Chuuk and Kosrae state governments, fiscal stability has been achieved in all states since FY2007, although balance is finely tuned. Public-sector employment has fallen, with the need to reduce expenditures outside the sector-grant areas. However, wages rose in the early part of the review period, reflecting the restructuring, annual wage drift, and payment of cost-of-living allowances (COLAs). Since FY2010, public-sector wage costs have been held in check with modest annual increases. The FSM has adopted a favorable external debt strategy, reflected in a low debt-to-GDP ratio, and the current level of external debt poses no significant risk to fiscal stability. Long-term fiscal management has entailed both the initial downsizing in Chuuk and Kosrae and the need for decrement management. Each state has prepared a long-term fiscal framework (LTFF) to enable an efficient adjustment to the annual decrements in real Amended Compact funding levels. These plans came into effect in FY2014. The FSM Social Security System has been modified to meet the deteriorating unfunded liability of the mid-2000s. With

adjustments to tax rates, income thresholds, and retirement provisions, the fund is now moving toward sustainability.

8. ***Macroeconomic Monitoring:*** At the start of the review period, the FSM was able to produce a limited set of basic macroeconomic statistics upon which to assess economic performance. Since that time, with U.S. technical assistance, the FSM has a full set of the major economic indicators, which include: gross domestic product (GDP), employment, wage data, consumer price index (CPI), banking statistics, balance of payments, international investment position, external debt, and government fiscal statistics. Local capacity is improving, and capacity building is supported by international donors.

9. ***Public Financial Management (PFM):*** The FSM initiated a program to adopt the World Bank and International Monetary Fund standards of Public Expenditure and Financial Accountability (PEFA), as a means to improving public financial management (PFM). However, after an external assessment was conducted at the national-government level, no further progress in improving PEFA or PFM has been achieved. In the area of financial accountability and control, all audits are now no longer qualified, and the national and state finance offices are generally adequately staffed. In FY2004 the FSM prepared a Strategic Development Plan (SDP) required by the Amended Compact to inform budget planning and implementation. The SDP was a quantitative document and provided a series of matrices with output and results-orientated indicators. While 10 years have passed since the SDP's publication, the majority of the material remains relevant. In November 2014, the FSM issued a draft 2023 Action Plan designed to prepare the nation for the end of U.S. direct sector grant assistance after FY2023 and re-invigorate parts of the reform agenda. A medium-term fiscal framework has not been adopted by the state or national governments, and although performance budgets have been prepared, they are not monitored or audited. As a result, there is no effective performance management. Financial management information systems (FMIS) provide adequate accounting and audit data, but they do not provide a basis for measuring output delivery, fiscal statistics, or improved budgeting.

10. ***State-Owned Enterprises (SOEs):*** The level of SOE subsidy in the FSM is less than 5 percent of GDP. The SOE sector has undergone consolidation, with liquidation or sale of the large fisheries investments to private management. However, other SOEs would benefit from more efficient and effective management.

11. ***Tax Reform:*** In the early 2000s, an ambitious tax reform program was proposed and adopted by the FSM, requiring action and coordination at the national and state levels. After many years of activity, two states, Pohnpei and Yap, dropped out of the program, and the FSM Congress repealed the proposed tax-reform legislation. Tax reforms to generate local revenue are critical during this period in light of the end of direct U.S. financial assistance in FY2023. The FSM tax regime inherited from Trust Territory days remains inefficient, lacks revenue buoyancy, and is ill-suited to meet the current needs of the FSM.

12. ***Private-Sector Regulatory Environment:*** An attempt to rationalize the regulatory environment for foreign investment was adopted in the early 2000s, demarking the division between the national and state levels. However, while laws were enacted and the system was put into place, Pohnpei opted to maintain a Foreign Investment Board, as did Yap, in response to

large-scale investment interest in tourism. During the review period, the FSM has failed to attract any significant foreign investment. As part of the Asian Development Bank (ADB) Private Sector Development Program (PSDP), legislation for long-term leasing of land was prepared to encourage development and mortgage-secured commercial lending. Only one state enacted the legislation. The World Bank's 2016 "Doing Business" survey ranks the FSM 148th out of 189 countries, which reflects declining competitiveness in an increasingly competitive global economy.

13. Overall, the policy, regulatory, and institutional environment needs further reforms, as envisaged in the earlier SDP or the current draft 2023 Action Plan, if the FSM is to be transformed into a growing economy. Economic performance during the review period has been poor, with weak implementation of the reform agenda and an inability to utilize substantial Amended Compact infrastructure-grant funding in a timely manner. Much attention during the review period was on adjustment to the sector-grant approach of the Amended Compact and subsequently in the decrement-management issue. For the prospects of economic advancement and budgetary self-reliance to improve, the reform agenda needs to become a top priority for the Government of the FSM.

3. Compact Trust Fund

14. ***The FSM Compact Trust Fund (CTF):*** The FSM CTF continued its pattern of growth at or near market performance. During the period of investment since the outset of FY2007, the annualized rate of return has been 6.51 percent, while the blended benchmark return was 6.81 percent. The estimated value of the CTF as of June 30, 2015, was $422 million. Assuming only the planned U.S. contributions, the fund would need to grow at 13.7 percent annually to achieve a level sufficient to provide maximum allowable annual distributions under the Trust Fund Agreement. However, achieving such a level is highly unlikely. If growth from the end of FY2015 is 7.0 percent in nominal terms through FY2023, the median value of the CTF is projected to reach $974 million. This is approximately more than half of the value the fund would need to be in order to provide for the maximum allowable distribution contemplated under the Trust Fund Agreement. In addition, certain aspects of the Trust Fund Agreement will require the attention of the CTF Committee, in collaboration with the U.S. and FSM Governments.

Recommendations

15. Four (4) recommendations are made in the following categories: Making Amended Compact Grant Assistance More Effective; Compact Trust Fund; Federal Programs; and Technical Changes to the Fiscal Procedures Agreement.

4. Making Amended Compact Grant Assistance More Effective

16. As noted by the U.S. Government Accountability Office (GAO), the FSM has not developed adequate data and reporting systems to be able to demonstrate progress in the health and education sectors, where the bulk of Amended Compact funding has been expended. It is clear that during the Amended Compact, there has been limited progress on monitoring of either results (outcomes) or deliverables (outputs). There is a need to ensure that health and education statistics and performance monitoring can be reliably used to inform the JEMCO decision-making regarding the effective use of Amended Compact sector-grant funding and monitoring by

U.S. grant managers. JEMCO could be made a more effective body by enacting the recommendation described below.

- Recommendation No. 1—At this time, the United States should continue funding support for maintenance of economic performance reporting for the FSM, and encourage the FSM to fund development and maintenance of reliable and verifiable health and education sector data and performance reporting systems.. JEMCO should consider allocating Compact sector funds in the health sector for these same purposes

1. The Trust Fund

17. ***The Compact Trust Fund Level:*** Both the U.S. and FSM governments have expressed concern that the Trust Fund as currently structured as well as the size of the corpus may not be sufficient to meet the needs of both Parties. The Trust Fund would benefit from actions by the original Parties to supplement the CTF from all sources, including from Subsequent Contributors. Some technical amendments may be desirable to better meet the objectives of the Original Parties after FY2023, and both Parties should consult on their respective objectives for the Trust Fund and the most appropriate path to achieving them.

- Recommendation No. 2—Secure additional funding from the FSM and from other donors and sources; assess the possibility of contributing unallocated (carryover) sector grant funds into the CTF; and
- Recommendation No. 3: Start discussions as soon as possible with GFSM for ways in which the Trust Fund can better meet the needs and objectives, including reducing the likelihood of a zero distribution year, of the Parties including potential Amendments to the Trust Fund Agreement.

2. Federal Programs and Services

18. Uncertainty as to the range and level of programs and services that U.S. federal services and agencies will continue to make available to the FSM after FY2023 has been raised by the GoFSM as a concern. As the end of the period of direct U.S. financial assistance under the Amended Compact approaches, uncertainty could impact decisions by potential investors and, critically for U.S. states, choices that individuals and families make about possible emigration.

- Recommendation No. 4—After the United States clarifies the status of U.S. federal programs, assistance, and services currently provided in the FSM, the United States should work with the FSM to appropriately assess which programs and services are appropriate to be continued after FY2023.

3. The FPA: Dates, Definitions, and Reporting Requirements

19. The Amended Compact sector grants and SEG are subject to the reporting and accountability requirements of the FPA. After 10 years of implementation, it is clear that a few changes would be beneficial to either correct errors or better reflect the conditions in which the FSM must fulfill its commitments.

- Recommendation No. 5—Amend the FPA so that:

- The due date for the Section 214 Annual Economic Report, as specified in Article V(1)(d), should be changed from February of each year to the end of July each year. The current timeline is difficult to achieve, given the desire to use audited figures, other reporting requirements, and limited capacity.
- For consistency with the Single Audit Act, the due date for the annual single audit as specified in Article VIII should be changed from the beginning of the third quarter to the end of the third quarter (June 30) of the fiscal year following the fiscal year under review.
- FPA Article VI, section 2, Program Monitoring, Performance Reports, and Records Retention, should be changed to specify that the fourth-quarter report format covers the full fiscal year, and the due date should be changed from 30 days to 60 days after the end of the fiscal year.

I. THE COMPACT FRAMEWORK

A. *Broad Features of the Amended Compact*

The Compact of Free Association between the United States and the Federated States of Micronesia began in 1986, following passage of U.S. Public Law 99-239. The Compact itself has no date of termination and remains in place indefinitely, subject to ongoing mutual agreement, or per its terms. Under the Compact, the U.S. provides economic and financial assistance, as well as certain federal programs and services, for a term of 15 years. Provisions related to immigration and migration, as well as certain provisions on security and defense matters, however, abide in perpetuity unless otherwise agreed.

B. *U.S. Financial and Economic Assistance*

20. A period of financial and economic assistance is provided for under the Amended Compact, including direct grant assistance, federal programs and services, and trust fund contributions.

1. MECHANISMS OF U.S. DIRECT GRANT ASSISTANCE UNDER THE AMENDED COMPACT (FY2004-FY2023)

21. Under the Amended Compact U.S. assistance is provided as sector grants, rather than general transfer payments. Such sector grants are defined in Section 211 and are to be used for assistance in education, health care, the environment, private-sector development, public-sector capacity building, and public infrastructure. The use of these sector grants is intended to be guided by a strategic plan, with allocations approved by the JEMCO and subject to a negotiated agreement defining administrative and fiscal payment procedures, called the Fiscal Procedures Agreement (FPA).

i. Section 211(c): the FSM Strategic Development Plan

22. Section 211(c) required a Development Plan to be "prepared and maintained" by the FSM. At the outset of the Amended Compact, the Government of the FSM fulfilled this requirement through the development of its Strategic Development Plan (SDP). The process undertaken was broadly participatory and involved a cross section of national and state government officials, private-sector representatives, and numerous civil society stakeholders. However, the SDP has not been well-integrated into annual budget submissions by the five governments (i.e., national government and four state governments) of the FSM. The FSM has more recently begun to address this issue, but, there has been no adopted update or official modification to the initial SDP. A better integrated and maintained SDP would better inform the JEMCO decision making process.

ii. The Fiscal Procedures Agreement

23. Although there were "fiscal procedures" that guided the transfer of funds to the FSM during the initial Compact period, they were limited to the administration of funds and were not as comprehensive as those that came into force at the outset of the Amended Compact. The FPA has transformed the application of financial assistance to the FSM.

24. Financial assistance during the Amended Compact is provided through specific grants. The FPA is based substantially on the Common Rule, which guides the award and implementation of grants from the U.S. federal government to state and local governments.

25. Recommendation X offers some changes to the FPA to be consistent with U.S. law and to better reflect the FSM's budget cycles and capacity.

iii. The JEMCO

26. The JEMCO was established by mutual agreement as part of the Amended Compact. Section 214 of the Amended Compact established the JEMCO with three members (including the chair) from the U.S. and two members from the FSM. Article III of the FPA specifies that the committee was "established to strengthen management and accountability with regard to assistance provided under the Compact, as amended, and to promote the effective use of funding provided thereunder." More specifically, the duties are defined in article III, section 5, as follows:

> (a) Review the Development Plan and other planning and budget documents of the Government of the Federated States of Micronesia, and monitor the progress made by the Government of the Federated States of Micronesia toward sustainable economic development and budgetary self-reliance in relation to its written goals and performance measures;
>
> (b) Consult with providers of United States Federal Grant programs and services and other bilateral and multilateral partners to monitor the use of development assistance from all sources as it relates to the allocation of financial assistance under the Compact, as amended;
>
> (c) Review Audits called for in the Compact, as amended, or this Agreement and actions taken or being taken to reconcile problems and qualified findings;
>
> (d) Review performance outcomes and other reported data in relation to the previous year's Grant funding levels, terms, and conditions;
>
> (e) Review and approve Grant allocations, performance objectives, and, where appropriate, assessment tools for the upcoming year;
>
> (f) Review and approve any change proposed by the Government of the Federated States of Micronesia to the sectors to receive economic assistance set forth in Title Two of the Compact, as amended;
>
> (g) Evaluate progress, management problems and any shifts in priorities in each sector, and identify ways to increase the effectiveness of United States assistance;
>
> (h) Review quarterly trust fund investment reports;
>
> (i) Comment on the comprehensive report prepared by the Government of the Federated States of Micronesia as required by section 214 of Title Two of the Compact, as amended, before it is submitted to the President of the United States; and
>
> (j) Attach special conditions to any or all annual Grant awards to improve program performance and fiscal accountability, and ensure progress toward macroeconomic goals.

27. Recommendation No. 1 discusses ways to make the JEMCO a more effective body and to improve monitoring and effectiveness of U.S. grant assistance.

2. Federal Programs and Services

28. Through the Amended Compact (Section 222) and other relevant laws the FSM is eligible for additional federal programs and services. Between Fiscal Year 2009 and Fiscal Year 2013, the FSM has accessed an average of $43.7 million annually in additional U.S. federal grants and programs outside of the Section 211 Sector Grants and Section 212 Audit. The programs were spread across several U.S. federal agencies: U.S. Department of Commerce, U.S. Department of Agriculture, U.S. Department of the Interior, U.S. Small Business Administration, U.S. Department of Homeland Security, U.S. Department of Education, U.S. Department of Health and Human Services, U.S. Department of Transportation, and the Institute of Museum and Library Services. These programs are found in the Catalog of Federal Domestic Assistance and are granted and administered as if they were operating in the United States. The Department of Transportation Airport Improvement Program provided the largest amounts of federal assistance outside of the Amended Compact Sector Grant assistance.

3. Trust Funds

29. Under the Amended Compact, a Trust Fund for the people of the FSM was established. Contributions to the Compact Trust Fund by the U.S. and FSM governments are governed by the schedule in Section 216 of the Amended Compact. According to that schedule, the U.S. government is obligated to contribute $7 million annually from FY2004 to FY2023 plus a cumulative amount that increases by $0.5 million annually beginning in FY2005 until FY2023. This additional amount corresponds to the amount by which the U.S. direct sector grant assistance provided under the Amended Compact is reduced in that fiscal year. A two-thirds inflation adjustment is also added to the U.S. contribution amount as indicated in the Amended Compact. The FSM government was obligated to contribute at least $30 million in specific tranches prior to September 30, 2004. U.S. contributions to the Fund were dependent upon these FSM contributions. There are no Subsequent Contributors to the Trust Fund for the people of the FSM; although the FSM has its own trust fund with a current value of approximately $40 million.

C. Military

30. Under the terms of the Amended Compact, the FSM granted the United States full authority and responsibility for all security and defense matters in and relating the FSM in perpetuity unless otherwise agreed. This authority and responsibility includes strategic access to FSM’s land and waterways as well as a U.S. right to deny access or use of FSM’s territory to military personnel of third countries or for such countries’ military purposes. The United States agreed to defend the FSM and its peoples from attack or threats thereof as the United States and its citizens are defended. The FSM also agreed to refrain from actions that the United States determines are incompatible with this authority and responsibility. FSM citizens volunteer to serve in the U.S. Armed Forces at rates great than many U.S. states and are eligible for admission to most U.S. Service Academies.

D. Immigration

31. In previous studies the GAO estimated that one-fourth of all citizens of the Freely Associated States (including the FSM) reside in the United States. In addition, Congress has provided $30 million annually for affected jurisdictions through FY2023. The description of internal and external migration patterns provided in Section XX indicates an out-migration rate of approximately 1.6 percent annually during the review period. This implies the movement into U.S. territories, Hawaii, and the U.S. mainland of approximately 15,500 Micronesians during the period covered by this review. The analysis of the impact of these movements is beyond the scope of this review.

II. Political and Social Context and Bilateral Relations

32. The FSM is a sovereign nation. While the government is free to conduct its own foreign relations, it does so under the terms of the Amended Compact.

33. The FSM is a constitutional republic composed of four states: Chuuk, Kosrae, Pohnpei, and Yap. Individual states enjoy significant autonomy, and their traditional leaders retain considerable influence. The elected unicameral national congress selects the president from among its four members elected from at-large state districts. Elections for the national congress are generally considered by observers to be free and fair and the March 2015 elections were generally considered by observers to be free and fair.

34. According to the State Department's Human Rights Report and the International Religious Freedom Report, an independent press, an effective judiciary, and a functioning democratic political system combined to promote freedom of speech and press. The constitution provides for freedom of expression but does not refer specifically to speech or the press; however, the government generally respects these rights.

35. As stated in the State Department's Human Rights Report the government did not restrict or disrupt access to the internet or censor online content, and there were no credible reports the government monitored private online communications without appropriate legal authority. Internet access was available in all four states, but service was slow with frequent outages. According to the International Telecommunication Union, approximately 30 percent of the population accessed the internet in 2014.

36. The constitution and law provide explicit protection against discrimination based on race, gender, religion, or language, but societal discrimination against women remained a problem. Kosrae passed a Family Protection Act in 2014, but the other three states have no laws against family violence. There are limited protections for persons with disabilities.

37. Although the law does not specifically provide for the right of workers to join a union, under the constitution citizens have the right to form or join associations, and by law national government employees can form associations to "present their views" to the government without being subject to coercion, discrimination, or reprisals. No law deals specifically with trade unions, the right to collective bargaining, or anti-union discrimination. There is no specific right to strike, but no law prohibits strikes.

38. The law provides criminal penalties for corruption by officials, and the government generally implements the law, but some officials reportedly engaged in corrupt practices with impunity.

39. As stated in the State Department's International Religious Freedom Report, although there is linguistic and cultural diversity within each of the country's four states, its religious character is overwhelmingly Christian. Several Protestant denominations, as well as the Roman Catholic Church, are present in every state. The United Church of Christ is the main Protestant

denomination. According to the FSM's Office of Statistics, in Kosrae 90 percent of the population is Protestant. In Pohnpei the population is evenly divided between Protestants and Catholics. In Chuuk an estimated 60 percent is Catholic and 40 percent is Protestant. In Yap an estimated 80 percent of the population is Catholic and the remainder is Protestant. The constitution states no law may establish a state religion or impair the free exercise of religion, although the government may fund non-religious activities in "parochial" schools. There were no reports of government actions affecting constitutional guarantees on the free exercise of religion.

40. As noted in the State Department's 2016 Trafficking in Person's report, the Government of the FSM does not fully comply with the minimum standards for the elimination of trafficking; however, it is making significant efforts to do so. The FSM was listed as a Tier 2 country.

III. Review of Economic Conditions

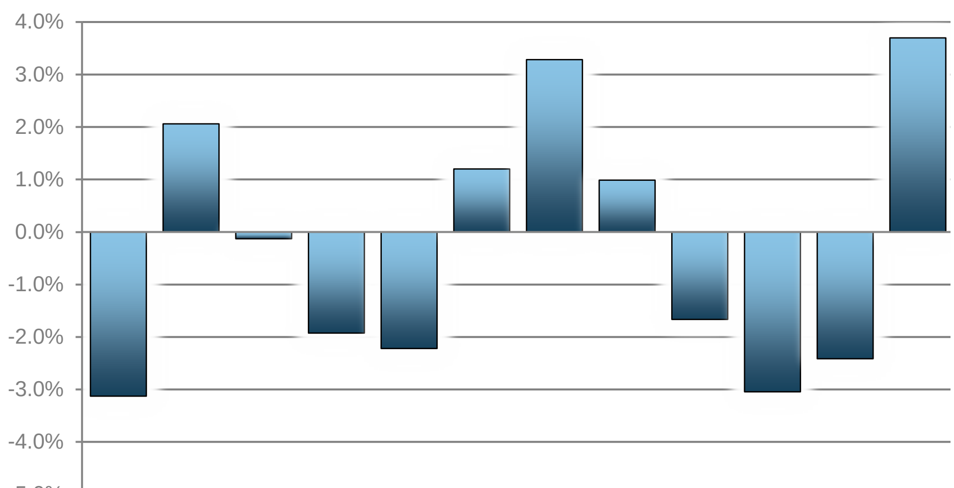
A. Growth and Employment

1. Developments in the FSM Economy

i. Major trends in economic activity

41. Economic developments during the period under review have been determined by a set of three major factors, which are: (i) adjustment from the initial Compact to the new fiscal provisions required under the Amended Compact; (ii) the global financial crisis in 2008; and (iii) large infrastructure projects funded through both the Amended Compact and FAA airport improvement grants. At the start of the Amended Compact in FY2004, the economy went into recession, as Compact receipts fell to the new, lower-negotiated levels, a reduction from $84 million to $76 million. A series of other factors also had strong negative impacts. These factors include: (i) the loss of the initial Compact energy grant; (ii) absorptive capacity constraints in the use of the Amended Compact sector grants; and (iii) the failure to fully utilize public-sector, infrastructure-grant assistance under the Amended Compact. During FY2004 the economy contracted by 3.3 percent (see Figure 3.1).

42. While some of the lost ground was recouped in the following year, growth turned negative in the subsequent three years, FY2006-FY2008, with GDP falling by 4.7 percent during the period, as a result of continuing adjustments under the Amended Compact and the impact of the international financial recession. In FY2007, the economy contracted by 2.2 percent. Chuuk and Kosrae were each required to implement a sizeable reduction in force (RIF), among other measures, to restore fiscal balance, as the use of the capacity-building sector grant for nonconforming purposes (i.e., those not identified in or consistent with the Amended Compact) was phased out. . There were some positive developments in fisheries, but by FY2008 the negative shock of the world recession had a strong impact on the four state economies. Higher fuel and food prices eroded real incomes, and GDP fell by a further 2.5 percent.



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
GDP growth	-3.1%	2.1%	-0.1%	-1.9%	-2.2%	1.2%	3.3%	1.0%	-1.7%	-3.0%	-2.4%	3.7%

Figure 3.1 GDP, constant prices 2004 (percent annual change)

43. FY2009-2012 saw modest growth, with FY2010 witnessing relatively strong performance. While the international economic conditions remained adverse in FY2009, strong growth in construction and FAA-funded airport renovation resulted in a return to positive growth of 1 percent. FY2010 turned out to be a good year for the FSM economy. This reflected continuing expansion in construction, as the use of the infrastructure grant picked up momentum, and the FAA projects injected additional funds. After several years of fiscal consolidation, FY2010 saw a return to growth in public administration, and the economy expanded by 3.2 percent overall. These trends continued in FY2011, although good performance in fisheries replaced public administration as a source of growth, and the economy expanded by 1.8 percent. In FY2012 construction activity declined, as a large increase in the use of the infrastructure grant was offset by a decrease in FAA expenditures. The economy remained flat and would have contracted, except for the strong performance in the fisheries sector.

44. FY2013 was a bad year for the FSM economy. The positive upward trend of the previous four years was reversed, as the economy contracted by 4 percent. Not only did the FSM economy decline, but the economies in each of the four states also shrunk for the first time since records began. Construction activity plunged by 26 percent, as FAA projects were completed, and management issues constrained the use of the infrastructure grant. Fisheries output also tapered, as many domestic purse seiners underwent dry docking.

ii. Developments in the public and private sectors

45. Overall, both the public and private sectors have contracted during the review period, with the public sector stabilizing post FY2008 and the private sector experiencing greater and longer narrowing. In FY2004, government activity contracted with the reduced Amended Compact funding levels, but it expanded in FY2005 and FY2006, due to higher expenditure levels in education and health, as absorptive capacity constraints were overcome, and the public sector adjusted to the new sector-grant approach (see Figure 3.2). The public sector withered between FY2007 and FY2008, resulting from phasing out the use of the capacity-building sector grant to fund nonconforming activities in Chuuk and Kosrae. Both states implemented RIFs and made significant cuts in public expenditures. With the contraction in Chuuk and Kosrae complete, public services have largely stabilized since FY2008.

46. The private sector contracted each year between FY2003 and FY2009. Overall, the private sector narrowed by 17.1 percent, or an annual average of 3.1 percent, reflecting the drop in demand in the economy. This lower demand resulted from the following: reduced levels of the Compact sector grants; failure to implement the infrastructure grant; and, from FY2008 to FY2009, the impact of the world recession and higher food and fuel prices on real incomes. In FY2010 and FY2011, with the passing of the recession, along with lower levels of inflation, greater use of the infrastructure grant, and large volumes of FAA Airport Improvement Program (AIP) projects, the private sector rebounded and grew by 18 percent during the two years. In FY2012 the private sector contracted, despite an expansion in fisheries, as output in construction and other parts of the economy declined. In FY2013 private activity declined further, with reductions in both construction and fisheries.

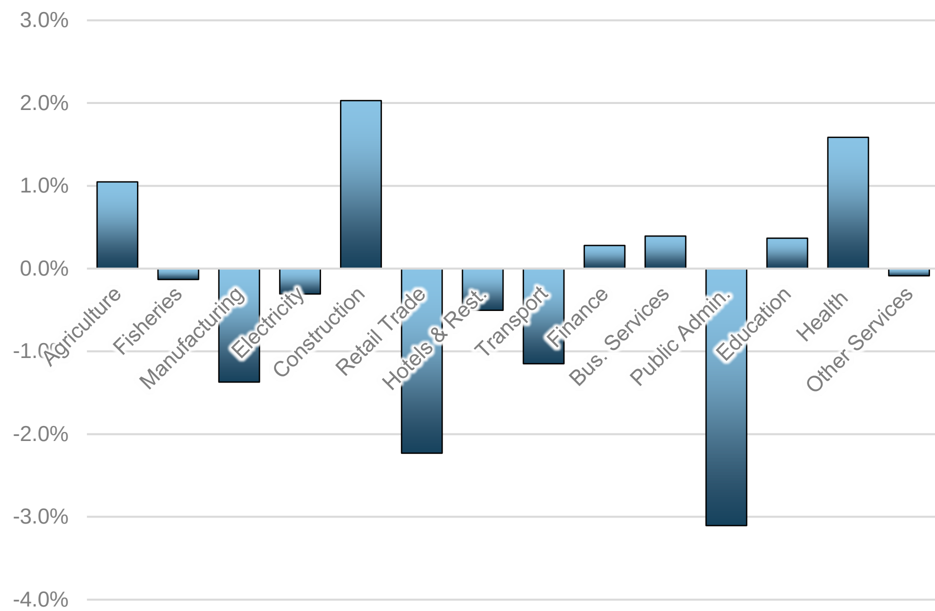


Figure 3.3 Contribution to GDP growth by industry, FY2003-FY2013 (percent)

Figure 3.2 FSM constant price GDP by sector, FY2004 prices (US$ millions)

iii. GDP by industry

47. Figure 3.3 summarizes the contributions of the various industries in the FSM to economic performance between FY2003 and FY2013. Agriculture has grown, reflecting increasing household production for home consumption, while fisheries output declined between FY2003 and FY2013, although there was trend improvement[2]. Manufacturing output declined, mirroring the closure of the Yap-based garment factories. Clearly, despite recent reductions in construction output in FY2013, the industry has made a significant contribution in maintaining the level of economic activity above what it would be otherwise. The decline in the wholesale and retail trade reflects the general adverse conditions prevailing during the period. The contraction in public administration was responsible for the major part of the overall drop in GDP. While education services remained largely unchanged through the Amended Compact, growth in health services has been a positive force.

48. Overall economic performance in the FSM since the Amended Compact came into force can only be described as dismal, and the economy contracted by a total of 3.9 percent. The economic developments that have occurred during the review period reflect an adjustment to the Amended Compact: overall contraction of the public sector due to lower annual amounts of U.S. assistance, with some offsetting improvement in education and health services, sparked by the sector-grant approach. In recent years, economic activity has been dominated by enhanced infrastructure investment, although recent management and capacity problems have brought this newfound source of growth to a halt. The private sector has failed to develop. Neither fisheries nor tourism, the two sectors in which the FSM has a comparative advantage, have shown any signs of growth. Only agriculture has increased marginally, reflecting greater household production for subsistence, a likely sign of lack of gainful opportunities elsewhere.

[2] Resulting from the high starting and low ending values for the series.

2. Economic Sector Developments

49. In agriculture, subsistence activities make a substantial contribution to GDP, while production for either the domestic or export market is small. The perception persists among local growers that returns from agriculture are low and slow to materialize, compared to other activities, such as nontraded 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 because of inefficiencies and low prices, but profitable export opportunities exist in niche agricultural products.

50. With the FSM's vast maritime resources, it might be anticipated that fisheries would be a well-developed sector, significantly contributing to GDP. However, the sector has not achieved the anticipated growth. Caroline Fisheries Corporation and Diving Seagull, formerly public-sector enterprises (PSEs) but now under private management or ownership, make a substantial contribution to GDP, but this varies significantly from one year to the next, depending on catch and prices.

51. The main benefit of the fisheries resource has been the annual rents earned from fishing access fees. These make a substantial contribution to national government revenues. In FY2013 income from fishing fees exceeded $35 million, mirroring the new arrangements under regional treaties and arrangements. The vessel royalty costs have risen and are set to rise further by 2015. The increase in projected revenues will generate a significant structural fiscal surplus at the national-government level.

52. Information on tourism suggests that visitor arrivals have declined by 2.1 percent per annum since the start of the Amended Compact, while the national accounts indicate a reduction of 3.3 percent per annum over the same period. It is clear that the performance of the sector has been lackluster and well below the potential for an industry designated, in the FSM's SDP, as a major growth sector of the FSM economy.

53. Many factors continue to hinder the development of a vibrant tourism industry. While attempts to improve the climate for foreign direct investment (FDI) have been made with donor assistance, the environment remains weak. According to the World Bank's 2016 "Doing Business" survey, the FSM ranks 148th out of a total of 189 nations surveyed, indicating that further reform must be completed before an attractive climate for private-sector investment is established. Difficulties in obtaining secure, long-term land leases are an impediment. Hotels currently operate at low capacity levels, and most of the facilities offer a standard of accommodation that is unattractive to international travelers. Growth in demand has been hampered by reliance on a single air carrier operating limited high-priced flights to and from a remote geographical location. While the FSM has much potential, particularly as a niche market in the ecotourism and dive areas, the current, generally low quality of tourism facilities and support services is unlikely to attract any but the most-hardened of travelers.

3. Incomes, Population, and Migration

54. The 2010 census indicated the population growth was falling by 0.4 percent. 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 Amended Compact. The negative economic growth rates in the FSM, and RIFs in Chuuk and Kosrae, resulted in large-scale migration to seek employment opportunities and better rates of remuneration in the United States.

55. Figure 3.4 indicates the rates of change in real incomes, employment, and migration in the four FSM states during the Amended Compact. GDP per capita has fallen in Chuuk by an annual average of 0.2 percent and remained largely unchanged in Kosrae, Pohnpei, and Yap. Employment opportunities have fallen in all states, with the exception of Pohnpei. The rate of out-migration[3], as measured by net movements of air passengers leaving the FSM between 2004 and 2012, has been remarkably similar in all FSM states, averaging 1.6 percent.

3 U.S. Department of Transportation. Data quality deteriorated in FY2013 and has not been used in the current analysis.

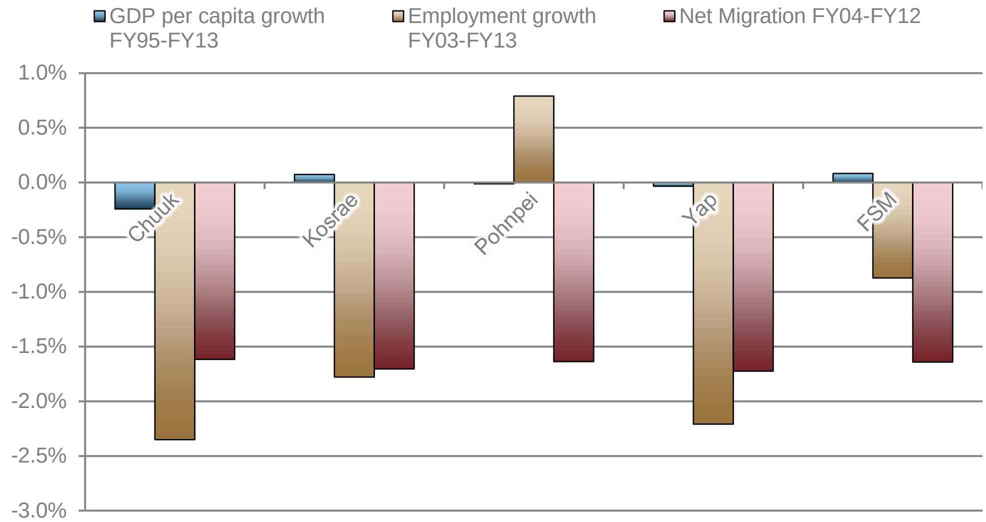


Figure 3.4 GDP per capita, migration, and population growth (annual averages)

56. The data in Figure 3.5 provides an indication of average real incomes during the reporting period. The implementation of the Amended Compact caused a reduction in incomes, as the economy adjusted to the new financial assistance structure. Incomes recuperated in the following two years but then fell, with the need for a second round of adjustments combined with the international recession in FY2008. During the FY2010-FY2012 period, incomes regained the lost ground and attained the highest level ever recorded. However, in FY2013 per capita GDP fell by 3.9 percent, reflecting the worst year for the economy since FY1997. Since the start of the Amended Compact, real GDP per capita has fallen by an average annual rate of 0.2 percent, in comparison with an annual average decline of 0.4 percent in real GDP. The slightly lower rate of decline in GDP per capita has been achieved by out-migration, which has

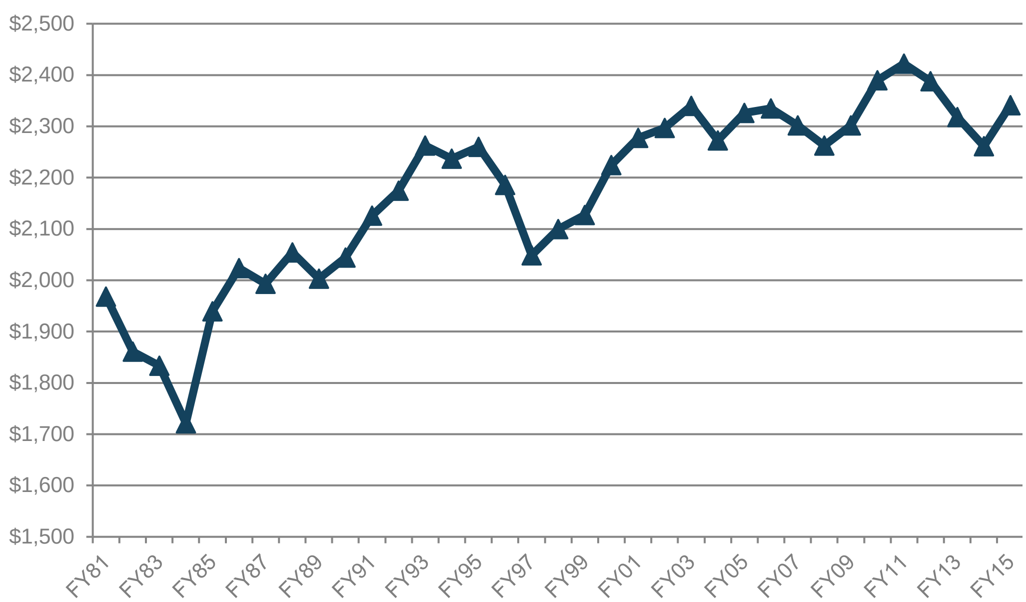


Figure 3.5 GDP and GNDI per capita, 1981-2015, constant prices 2004 (US$)

sustained the average standard of living for those remaining behind.

57. Figure 3.6 illustrates GDP per capita over time by state. The level of current GDP per capita in Yap is 150 percent higher than in Chuuk, while that in Pohnpei and Kosrae is 109 percent and 74 percent higher, respectively. Attributions of the differences are complex and reflect many factors. Under the FSM-developed and managed Amended Compact revenue-sharing formula between the states, the smaller states receive a higher proportion. On this basis, Kosrae should top the list, but, in fact, it achieves third place. The remote location and particularly small size of Kosrae imposes special constraints. While Pohnpei benefits significantly from being the host of the capital, Yap has attained the highest per-capita levels. Growth and development polices have played an important part. While the disparities were less pronounced at the start of the Amended Compact, higher growth rates have enabled states to improve the standard of living. In Chuuk, per-capita incomes have remained largely stagnant throughout the period. In Kosrae, there have been large variations over the years, and the trend shows improvement. The FAA-funded projects and Amended Compact infrastructure projects boosted GDP per capita in FY2011 and FY2012. With the completion of the airport renovation, a return to previous levels will take time. In Pohnpei, the trend indicates a substantial improvement in standards of living, although the recent decline in construction activity has again had a negative impact. In Yap, standards of living have stagnated.

4. Employment

58. Figure 3.7 represents trends in private- and public-sector employment since FY2003. In FY2003-FY2012, public-sector employment has shown an oscillating trend, corresponding to the fiscal position in different states. A lack of fiscal discipline in Chuuk, particularly in FY2006, is reflected in sharp increases in total FSM public-sector employment levels. However, with the further need to compress expenditures—a result of the phase-out of the use of the capacity-building grant to fund government operations in both Chuuk and Kosrae—public employment

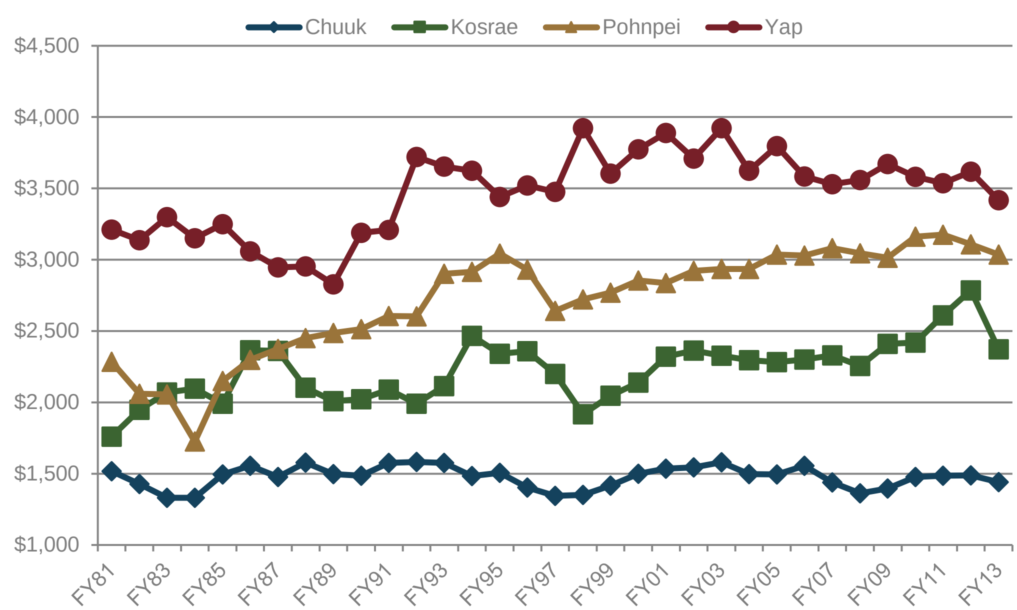


Figure 3.6 GDP per capita in Chuuk, Kosrae, Pohnpei, and Yap, 1981-2013, constant prices 2004 (US$)

fell in FY2013.

59. From FY2003 to FY2008, private-sector employment declined significantly, and adjustments were made during the initial three years of the Amended Compact. More recently, during the FY2009-FY2011 period, private-sector employment grew strongly, fueled by the need for additional jobs in construction. However, as growth in construction peaked and then contracted, private-sector employment fell during the FY2012-FY2013 period.

5. Wages

60. While the FSM labor market is relatively free from imposed regulatory restrictions, it is distorted by high public-sector wage rates; the ease of migration to the United States; the availability of higher wages in Guam and other U.S. labor markets; and the opportunity cost of labor in the subsistence sector. Average wages between FY2011 and FY2013 were 205 percent higher in government 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 it influences the allocation of labor among the sectors. FSM policy makers are constrained in their ability to influence distortions in the labor market. The effect of unrestricted external migration is part of the privileges extended to certain FSM citizens under Title III of the Amended Compact. Figure 3.8 indicates recent developments in nominal and real wages in the private and public sectors. Nominal wages have grown on average by 2 percent and 2.7 percent per annum in the private and public sectors, respectively. However, in real terms, wages, after adjustment for inflation, have declined by 1.7 percent and 2.3 percent in the two sectors, indicating a decline in the standard of living.

B. Inflation and Monetary Developments

1. Prices

61. Figure 3.9 provides information on the rate of annual change in the FSM consumer price index (CPI). During the initial years of the Amended Compact, inflation was moderate and

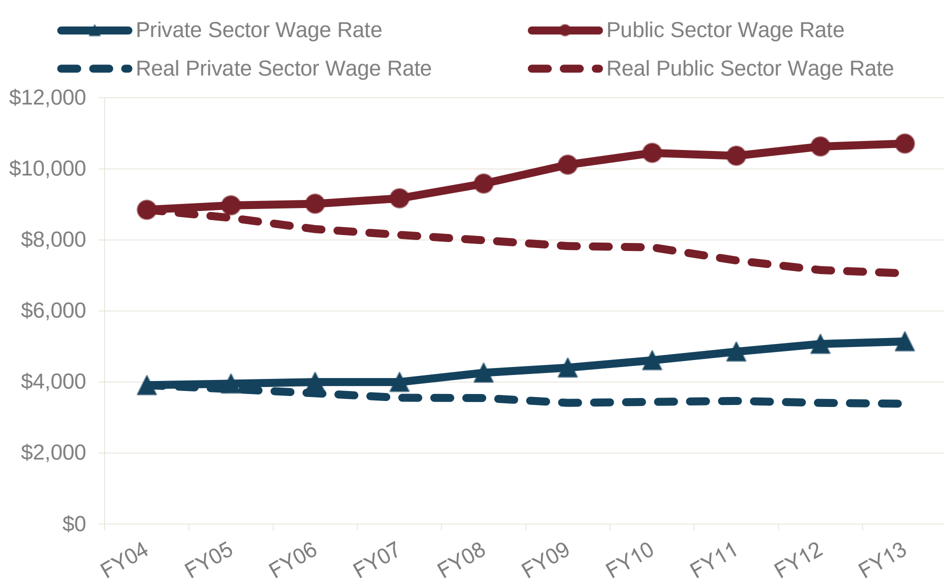


Figure 3.8 Nominal and real wages, private and public sectors, FY2004-FY2013

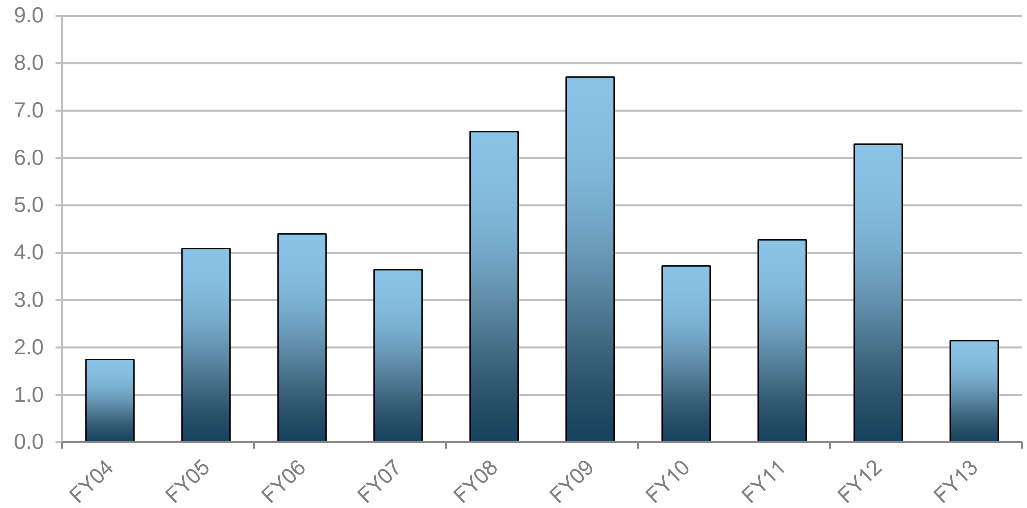


Figure 3.9 Change in consumer price index (year-on-year percent change)

averaged 3.5 percent through FY2007. However, in FY2008 and FY2009, with the onset of the global recession, inflation peaked, reaching 6.5 percent and 7.9 percent, respectively. Inflation has been moderate during most of the remainder of the review period. Although it rose again in FY2012, it moderated in FY2013, falling back to 2 percent. The main forces influencing the rate of inflation have been: (i) increases in imported food prices in FY2008 and again, to a lesser extent, in FY2012; (ii) higher utility prices at the start of the Amended Compact, because of the loss of the energy grant under the initial Compact; and (iii) surges in world petroleum and utility prices in FY2008 and FY2011.

2. Money and Banking

62. With the use of the U.S. dollar as the FSM's official currency, the FSM Government's macroeconomic policy and adjustment have been limited to the use of fiscal policy. As a result, domestic interest rates are closely aligned with those of the United States. Deposit interest rates observed in the market are broadly similar to those throughout the U.S., while lending rates are generally higher, reflecting the additional risk and costs of doing business in the FSM. The banking system is regulated by the FSM Banking Board, which is developing the 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. There is one locally owned bank, the Bank of the Federated States of Micronesia and one U.S. bank, the Bank of Guam, which is subject to U.S. federal supervisory requirements. The programs and services of the Federal Deposit Insurance Corporation are made available to the Bank of the FSM until 2023, as provided by the Amended Compact, and subject to U.S. banking laws and other requirements under a subsidiary agreement to the Amended Compact.

63. Figure 3.10 indicates trends in bank deposits and loans. With regard to deposits, the data indicate a static period between FY2003-FY2008. Since FY2008, the deposit base has grown more rapidly, averaging 12 percent during the FY2008-FY2013 period. The lack of financial deepening during FY2003-2008 is consistent with the lackluster performance of the economy, and the expansion since then represents improvements in economic conditions. The large

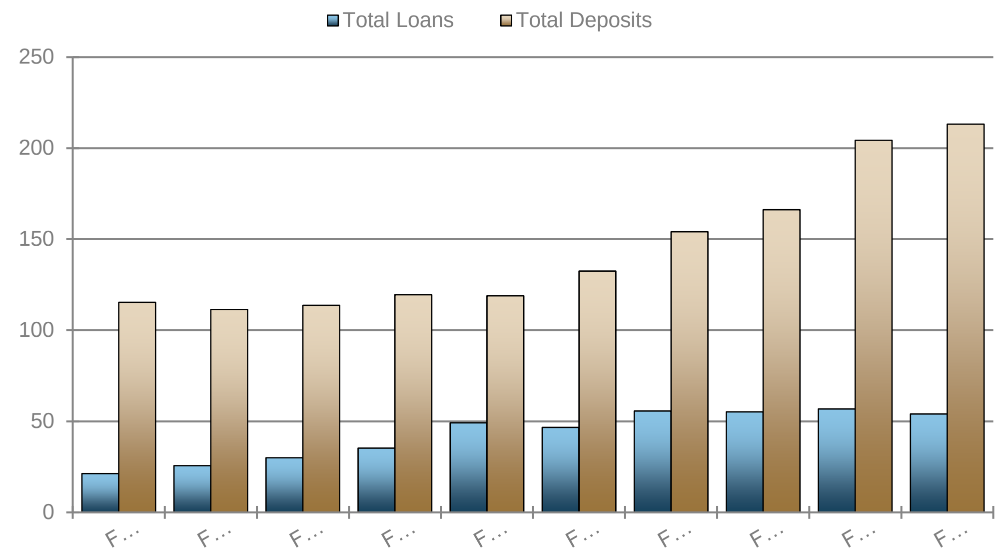


Figure 3.10 Commercial bank loans and deposits, end of period (US$ millions)

difference between the value of deposits and loans is invested by the banks offshore. Reflecting the trends in deposits and domestic credit, the level of foreign assets stagnated between FY2004 and FY2008, averaging $95 million, but rose strongly through the remainder of the period under review, attaining $172 million in FY2013.

64. Regarding lending, at the start of the review period, the level of outstanding domestic credit was very low, at $19.3 million, reflecting consolidation of the sector. Since then, lending has been more active, and the level of outstanding credit has grown by $16 million since FY2004 and stood at $36 million at the end of FY2013. The difference between loans and deposits indicates the large level of liquidity in the FSM banking system and reinforces a widely observed phenomenon in the Pacific Islands region: as a factor of production, capital is not in short supply. Reflecting the trends described above, the loans-to-deposit ratio had fallen to a very low level of 18 percent at the start of the Amended Compact. The ratio improved through FY2008 to 41 percent, but it has since slipped back to 25 percent in FY2013.

65. Because of 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. Consumer lending has grown by an annual average of 6 percent during the Amended Compact and, apart from a weak point in the recessionary years of FY2008 and FY2009, has been buoyant (Figure 3.11). Commercial credit grew rapidly through FY2011, by an annual average rate of 16 percent. In FY2008, the newly created FSM Petroleum Corporation (FSMPC) was extended a large credit facility by the Bank of Guam to initiate operations, but it was paid down early in FY2009. During the last two years, lending to the commercial sector has fallen.

C. External Debt

1. External-Debt-Management Strategy

66. The FSM has adopted a prudent, external-debt-management strategy during the period of review, and external borrowing has been modest. The current portfolio of government external debt is represented by debt to the Asian Development Bank (ADB), which totalled

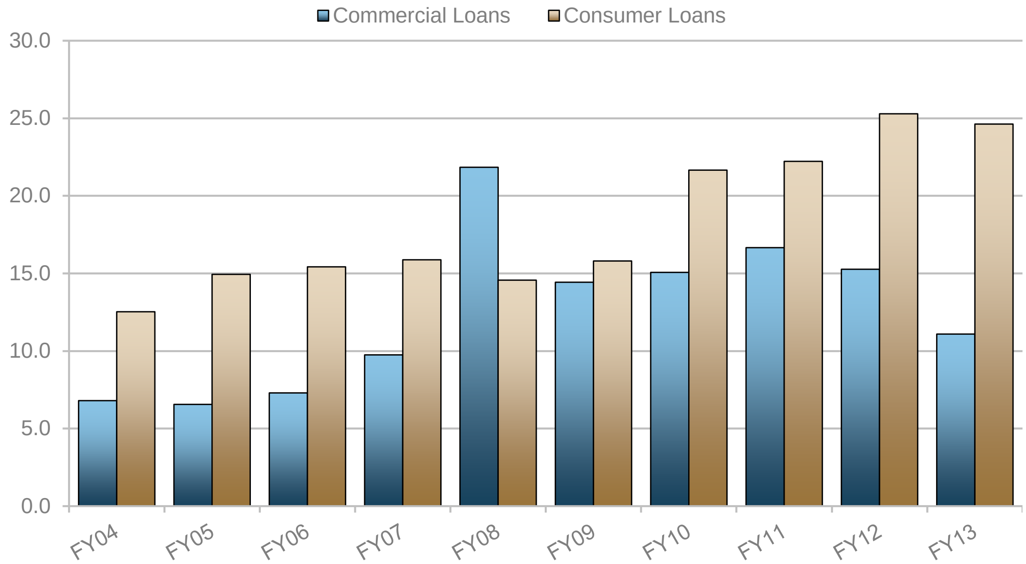


Figure 3.11 Commercial bank credit by sector, end of period (US$ millions)

approximately $57.3 million in FY2013, all of which has been lent directly to government. The ADB offered the Private Sector Development Program (PSDP) in FY2003 and the Basic Social Services (BSS) loan in FY2004, but drawdowns under both programs were not extensive, as several of the FSM states failed to qualify for the loans or meet the conditions for second-tranche drawdown (outstanding debt under both loans is $12 million). In FY2008, the FSM made the first drawdown under the ADB Omnibus Infrastructure Development loan to finance specific projects in the FSM states (outstanding debt is $13 million). For government guaranteed debt, the main item is financing provided by the U.S. Rural Utilities Service to the FSM Telecommunications Corporation. This loan amount stood at $23 million in FY2008, but in FY2009 it rose significantly, with the drawdown of $12.1 million to finance the installation of a fiber-optic cable connection (outstanding debt is $29 million).

67. The FSM external-debt level is now very favorable (see Figure 3.12). With a debt-to-GDP ratio of just 28 percent in FY2013, the FSM's debt level is low by Pacific Island standards. Furthermore, with the remaining debt on concessional terms, the debt-service ratio in FY2013 is projected at the low level of 10 percent of national government domestic revenues.[4] Each of these ratios is overstated, in light of the fact that the FSM holds a sinking fund equal in value to the amount outstanding for the Public Sector Reform Program, Private Sector Development Program, and Basic Social Services loans. Adjusting for this asset held against external debt, the debt-to-GDP ratio in FY2013 would be 18 percent, and the corresponding debt-service ratio would be 8 percent of national government domestic revenues.

[4] While most external debt has been on-lent to the state governments, the liability rests with the national government

D. Fiscal Developments

1. Fiscal Policy Framework

i. Compact Arrangements

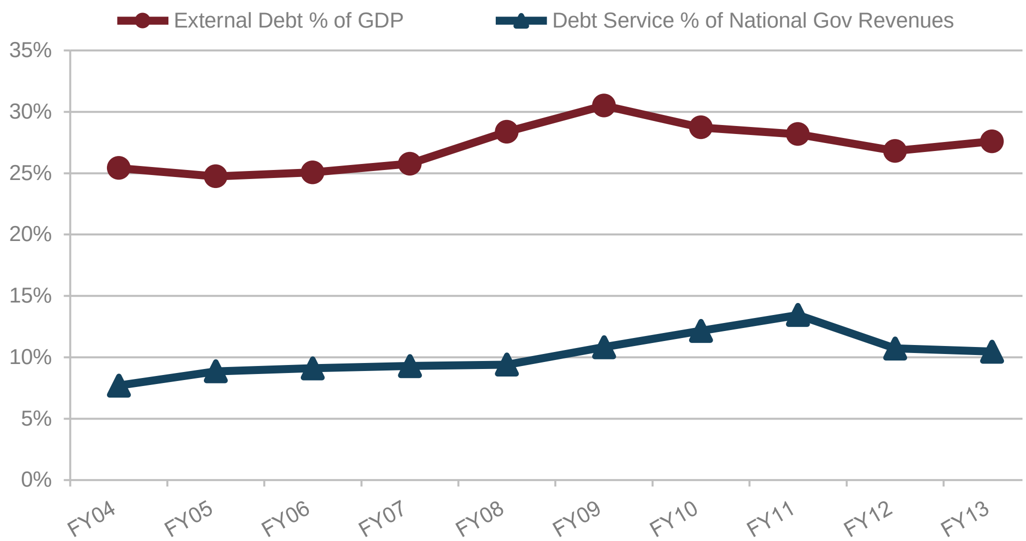


Figure 3.12 FSM external-debt ratios

68. The Amended Compact entry into force initiated a wholly new fiscal framework for the FSM. The structure entailed a series of sector grants earmarked for education, health, environment, private-sector development, capacity building, and infrastructure. The Amended Compact also established a Trust Fund for the people of the FSM, which was designed to provide an additional source of revenue after FY2023 to be used in the specific sectors described above. Table 3.1 shows the aggregate structure of the annual Amended Compact grants and the contribution to the CTF. The U.S. will contribute to the FSM $92 million, partially adjusted for inflation, in accordance with the schedule set out in Table 3.1. The annual sector grants started at

Table 3.1 U.S. annual Compact grants and contributions to the Trust Fund (US$ millions)

	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

a level of $76 million in FY2004 but are to be annually reduced by $0.8 million from FY2007 onward, which will be deposited into the CTF to accumulate.

69. While avoiding large shocks to the system, the decrement requires an annual compression of expenditures from FY2007 onward. This compression, coupled with the two-thirds inflation adjustment, means an annual reduction in real resources of about 2 percent. This will require active fiscal policy adjustments, unless the FSM develops a policy regime that will attract and encourage private sector investment and sustainable economic growth sufficient to offset the decline in resources from Amended Compact sector grants.

70. The annual budget allocations are determined through the JEMCO. The United States has three members and the FSM has two. Each year the FSM presents its sector-grant submissions to the U.S. in advance of the JEMCO meeting, which is convened in late August to make the annual budget allocations before the new fiscal year starts on October 1.

71. In keeping with the sense of Congress regarding infrastructure investment, JEMCO resolved that at least 30 percent of Amended Compact sector grants be allocated in the infrastructure sector, effective in FY 2006. Finally, implementation of the Amended Compact entails accountability requirements that are specified in the FPA. Taken as a whole, the fiscal arrangements of the Amended Compact have had a wide-ranging impact on the conduct of fiscal policy and management in the FSM.

ii. The Domestic Framework

72. Fiscal policy is formulated individually by the national and 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 FY2013, national taxes (excluding the captive insurance corporate tax) amounted to $25.2 million, while the four states collected an additional $8.6 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. In 2006, the FSM Congress enacted legislation (modified in 2009) to establish a captive insurance market and corporate tax registry in the FSM. In essence, the law provides lower tax rates than those in Japan and provides an incentive for firms to register in the FSM. In FY2009, the FSM collected its first receipts under the system and raised $4.4 million in FY2013.

73. By constitutional mandate, at least 50 percent of nationally imposed taxes (and 80 percent of the fuel import tax) must be shared with the state in which the taxes were collected. In the case of the corporate tax registry, the revenues are not collected in the FSM, and the tax is not subject to the revenue sharing agreement. While overall tax effort remains low relative to other Pacific Islands, there has been some gradual increase over time. In FY2013, tax revenues equated to 12 percent of GDP. The small increase is primarily the result of: policy changes to the import tax that shifted the base from free on board (f.o.b.) to cost, insurance, and freight (c.i.f.); rate increases on beer and tobacco (effective FY2005); and the new captive insurance scheme in FY2009. These increases were offset in FY2007 by deductions from the gross-receipts tax (GRT) for payroll costs. It is likely that collection performance has improved modestly.

However, tax administration and, in particular, compliance and audit functions need strengthening.

74. Nontax revenues continue to be dominated by fishing-access fees, which in FY2013 represented 35 percent of all domestic revenues. The national government manages pelagic fisheries resources and retains all revenues from the licensing fees. After an extended period of decline, fishing-access fees have grown strongly in recent years, and $35 million was collected in FY2013. Indications are that continued strong growth may be anticipated over the medium term, reflecting the rise in the Vessel Day Scheme (VDS) rate from $5,000 a day in FY2012 to $6,000 in FY2014, and an agreed increase to $8,000 in FY2015.

75. The national government is the prime grantee in distributing to each government, according to mutually agreed-upon formulas, the grant funding received from the United States under the Amended Compact. Until FY2014 the national government received 10 percent of grants, and the remainder was distributed to the states, based on a formula that splits roughly 30 percent of funding evenly among the four states and the remaining 70 percent according to population. As part of the FY2014 JEMCO budget allocations, the national government relinquished part of its share. The existing support provided through the sector grant for the College of Micronesia will fall by $700,000 a year until $1 million remains. These funds will then be allocated to the states.

76. 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 "carryover" 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; consequently, legislative bodies must make appropriations without an accurate appraisal of each government's true fiscal position.

77. The national and state governments conduct budgetary operations through a series of separate funds, the most important of which is the general fund. Expenditures from the general fund are largely unrestricted in nature, but there is limited flexibility or authority to use resources from the other funds. Under the Amended Compact, all U.S. assistance is recorded as special funds and are restricted to the purposes for which they were provided.

2. FSM Fiscal Performance

i. Fiscal developments

78. The first five years of the period under review witnessed difficult fiscal adjustments, as the nation adapted to the new arrangements (Figure 3.14). In FY2004, the FSM recorded a deficit of $39 million (15 percent of GDP). This deficit reflected the need to transfer $30 million to the CTF. It also showed Compact funding at levels below those prevailing at the end of the initial Compact. In the subsequent years of FY2005 and FY2006, deficits of $14 million—or 5 percent of GDP in each year—were recorded. The Amended Compact restricted the use of resources to specified sectors and prohibited their use to fund the general government. To ease the adjustment, the U.S. permitted the use of the capacity-building grant to fund general activities, provided these were transitioned out over a five-year period. There was a gradual improvement in the fiscal position in FY2007 and FY2008, as the nation adjusted to the new requirements and implemented RIFs in Chuuk and Kosrae.

79. By FY2009 the adjustment to the new, sector-grant approach was complete, and the FSM recorded a surplus of $5.2 million (1.9 percent of GDP) for the first time in the review period. In FY2009 the FSM received significant FAA grants for airport capital improvement projects, which pushed up both revenues and expenditures significantly. In FY2010 there was further FAA infrastructure investment, and a slightly smaller surplus of $1.4 million was achieved (0.5 percent of GDP). In FY2011 the expansion in airport renewal was maintained, and the nation began to make significant use of the Amended Compact infrastructure sector grant. However, the FSM recorded a small deficit of $1.8 million 0.6 percent of GDP).

80. In FY2012 the FAA projects began to decline but were offset by a further increase in use of the infrastructure sector grant. The FSM also experienced the benefits of the Parties to the Nauru Agreement (PNA) through the Vessel Day Scheme (VDS), and the national government was the beneficiary of a large fiscal surplus of $8 million. With all FSM states running small fiscal deficits, with the exception of Kosrae, an overall FSM-wide surplus of $2.5 million (0.8 percent of GDP) was achieved. In FY2013 expenditures on FAA projects fell by half, and the previous growth in the use of the infrastructure grant was constrained by management weaknesses and disorganization. Meanwhile, fishing-fee revenues rose to record levels. As state governments continued to run small deficits, the national government ran a surplus of $11

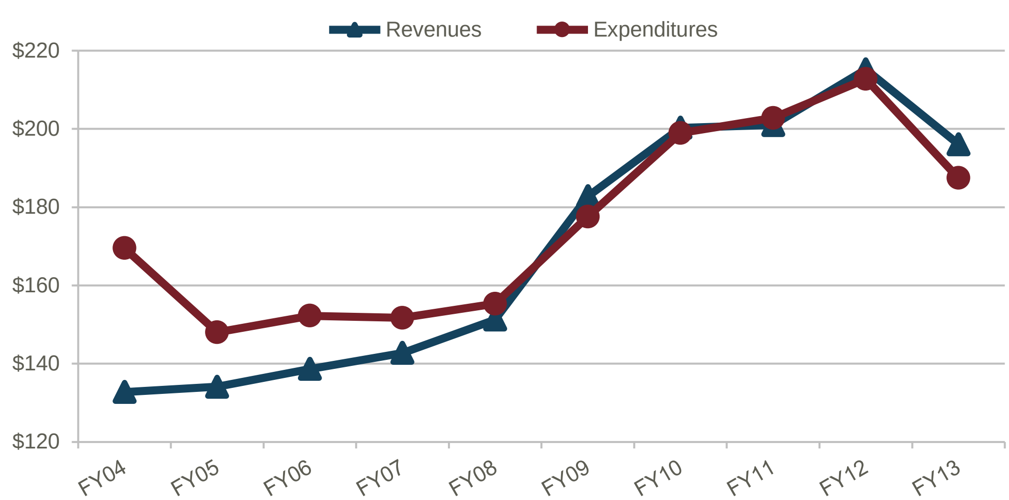


Figure 3.13 FSM consolidated revenues and expenditures (US$ millions)

million, and the FSM recorded an overall surplus of $9 million (2.8 percent of GDP).

ii. Structure of the fiscal accounts

81. Taking a long-term view of the structure of the fiscal accounts, it is noted that the government sector has played a dominant role in the economy, but its significance has diminished (Table 3.3 Comparative analysis of fiscal structure, FY1995, FY2004, and FY2013

FY95	Chuuk	Kosrae	Pohnpei	Yap	National	FSM
Grants as % of GDP	45%	81%	30%	49%	9%	50%
Grants as % of Total Revenue	84%	84%	79%	68%	38%	66%
Tax Revenue as % of GDP	7%	11%	11%	11%	8%	10%
Total Expenditure as % of GDP	54%	87%	43%	72%	23%	77%
Overall Balance as % of GDP	1%	10%	-6%	0%	1%	0%
FY04						
Grants as % of GDP	24%	40%	20%	25%	8%	31%
Grants as % of Total Revenue	74%	72%	58%	67%	38%	56%
Tax Revenue as % of GDP	7%	7%	6%	9%	4%	12%
Total Expenditure as % of GDP	48%	55%	39%	-54%	23%	71%
Overall Balance as % of GDP	-16%	-14%	-1%	-17%	-3%	1%
FY13						
Grants as % of GDP	30%	41%	-21%	28%	14%	36%
Grants as % of Total Revenue	77%	80%	19%	68%	44%	57%
Tax Revenue as % of GDP	7%	7%	14%	6%	6%	12%
Total Expenditure as % of GDP	38%	51%	21%	-43%	28%	60%
Overall Balance as % of GDP	0%	1%	0%	-2%	4%	1%

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 In FY2009 and FY2010 unusually high FAA grants for airport renewal distort the trend figures.

Table 3.3 Comparative analysis of fiscal structure FY1995, FY2004, and FY2013" \f tt

FY95	Chuuk	Kosrae	Pohnpei	Yap	National	FSM
Grants as % of GDP	45%	81%	30%	49%	9%	50%
Grants as % of Total Revenue	84%	84%	79%	68%	38%	66%
Tax Revenue as % of GDP	7%	11%	11%	11%	8%	10%
Total Expenditure as % of GDP	54%	87%	43%	72%	23%	77%
Overall Balance as % of GDP	1%	10%	-6%	0%	1%	0%
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Grants as % of GDP	24%	40%	20%	25%	8%	31%
Grants as % of Total Revenue	74%	72%	58%	67%	38%	56%
Tax Revenue as % of GDP	7%	7%	6%	9%	4%	12%
Total Expenditure as % of GDP	48%	55%	39%	-54%	23%	71%
Overall Balance as % of GDP	-16%	-14%	-1%	-17%	-3%	1%
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Tax Revenue as % of GDP	7%	7%	14%	6%	6%	12%
Total Expenditure as % of GDP	38%	51%	21%	-43%	28%	60%
Overall Balance as % of GDP	0%	1%	0%	-2%	4%	1%

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 In FY2009 and FY2010 unusually high FAA grants for airport renewal distort the trend figures.

82. Table 3.4). Government expenditures have declined as a share of GDP, from an estimated 71 percent in FY2004 to 60 percent in FY2013. In future years, the use of the Amended Compact infrastructure grant will hopefully improve, while FAA renovations will taper off. On the revenue side, the dependence on external grants as a percentage of GDP has fallen significantly. Grants represented31 percent in FY2004and are estimated at 36 percent in FY2013. Grants as a percentage of total revenues were 57 percent in FY2013 and have changed minimally during the review period. Tax effort as a share of GDP is low in the FSM but has grown, to 12 percent in FY2013, and indicates the scope for tax reform without increasing tax rates to punitive levels.

iii. Structure of the FSM tax system

83. The tax system in the FSM is based on a tax system inherited from—and largely unaltered since—Trust Territory days. There are three major taxes: wages tax, the business gross-receipts tax (GRT), and import duties, each of which collects a very similar level of revenue. The FSM's tax base has grown by an annual average of 2.6 percent over the review period, less than the growth rate of nominal GDP (3.5 percent). This represents an overall buoyancy ratio of 0.75, revealing the inefficiencies of the current system, and indicates the need for tax reform.

84. Wage earners pay 6 percent of income, up to a threshold of $11,000, and above that, 10 percent. Those earning less than $5,000 have a tax-free threshold of $1,000. In FY2013 the wages tax collected $7.9 million. Recent estimates of the wage tax buoyancy indicated a ratio close to 1, compared to the tax base of compensation of employees. A ratio of greater than 1

Table 3.3 Comparative analysis of fiscal structure, FY1995, FY2004, and FY2013

FY95	Chuuk	Kosrae	Pohnpei	Yap	National	FSM
Grants as % of GDP	45%	81%	30%	49%	9%	50%
Grants as % of Total Revenue	84%	84%	79%	68%	38%	66%
Tax Revenue as % of GDP	7%	11%	11%	11%	8%	10%
Total Expenditure as % of GDP	54%	87%	43%	72%	23%	77%
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Overall Balance as % of GDP	0%	1%	0%	-2%	4%	1%

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 In FY2009 and FY2010 unusually high FAA grants for airport renewal distort the trend figures.

could be expected, as taxpayers receive increased earnings and move through the tax bands.

85. The GRT is levied at 3 percent of business turnover and is intended as a proxy income tax, although the incidence is comparable to that of a sales tax. In FY2013 the tax raised $8.8 million. The tax suffers from a cascading effect, such that each sale from one business to another multiplies the tax yield and distorts resource allocation. To encourage the external sector, exports have been exempted from the tax. In 2007, the government implemented tax measures to provide relief to the private sector by allowing firms to offset payroll costs in the calculation of the gross receipts tax. The impact of the reductions on tax effort was minor. Estimates of the GRT buoyancy indicate a ratio of 1.12, signifying that although the tax has many undesirable properties, it has provided the government with an elastic source of revenue.

86. Customs duties are the remaining tax category. They have displayed an erratic trend through the review period, averaging 2 percent per annum during this time, and collected $8.5 million in FY2013. The general rate of import taxes is 4 percent, while food is subject to a lower rate of 3 percent. Gasoline and diesel fuel are subject to 5 cents per gallon, while alcohol and tobacco are subject to the usual higher rates. In the early part of the review period, to enhance revenue effort, legislation was passed to implement additional tax measures to increase revenues on beer and tobacco. Estimates of the buoyancy ratio for customs duties indicate a ratio of 0.52, reflecting the inefficiencies of the duties as a form of revenue collection, which are subject to a variety of leakages and concessions.

iv. Fiscal issues

87. Absorptive capacity constraints have been a major problem, both at the start of the review period and during the last few years. For the five operational grants - i.e., health care, education, environment, public sector capacity building, and private sector development – utilization rates were low at the start, but these slowly improved, as implementation of the new fiscal assistance structure became familiar.

88. In the case of the infrastructure sector grant, implementation problems and an inability to fulfill the requirements of the awards have been extreme. Of the $228 million awarded during the FY2004-FY2013 period, the FSM has been able to utilize only $103 million, or 45 percent, of available funding. In FY2012, when some implementation issues had begun to be resolved, $28.5 million was used, out of the total $24.2 million available for the year. However, in FY2013 utilization of the infrastructure sector grant fell, and only $16.5 million was drawn down, as implementation was constrained by management issues, lack of clarity in FSM priorities, and conflicts between the national level project management unit (PMU) and state governments.

89. **Error! Reference source not found.** indicates the improving fiscal position of the state and national governments during the first five years of the review period. In the last four years, the position of the state governments has deteriorated, as the real value of the sector grants has declined. However, the national government has benefited from growing tax revenues from the captive-insurance market and rising fishing revenues under the Parties to the Nauru Agreement. The national government’s fiscal surplus will continue to strengthen, as the states continue to experience mounting fiscal pressure.

IV. POLICY REFORM

90. At the start of the Amended Compact, the FSM commenced a process to identify its development strategy for a new era and began work on the preparation of a Strategic Development Plan (SDP), as required under section 21, and further described in the new Fiscal Procedures Agreement (FPA), to provide the framework upon which to base the annual requests for Amended Compact sector grants.

The Government of the Federated States of Micronesia shall prepare and maintain an official overall development plan. The plan shall be strategic in nature, shall be continuously reviewed and updated through the annual budget process, and shall make projections on a multi-year rolling basis. Each of the sectors named in subsection (a) of this section, or other sectors as mutually agreed, shall be accorded specific treatment in the plan. Insofar as grants funds are involved, the plan shall be subject to the concurrence of the Government of the United States.

91. From March 29-April 2, 2004, the FSM convened the Third FSM Economic Summit. The summit was attended by 400 participants, representing the four FSM states, traditional leadership, private sector, national and state governments, nongovernmental organizations, churches, women's and youth groups, government officials, and representatives of foreign governments and donor institutions. The theme of the Summit was, *The Next 20 Years: Achieving Economic Growth & Self-Reliance.* The objectives of the summit were:

- To achieve consensus on an overall strategy consistent with the theme of achieving economic growth and self-reliance;
- To build awareness of the economic structure of the Amended Compact provisions and the likely impact on the FSM economy; and
- To improve implementation and monitoring of the outcome of the planning process.

92. The summit participants were presented with two sets of materials: draft sector SDP chapters and sector planning matrices. Both were debated in committee, and the matrices were adopted by the summit and subsequently by the FSM Congress.

93. The summit provided the opportunity for the leadership to consider the progress attained during the 17 years of the original Compact. While implementation of that Compact saw the emergence of a stable democracy, economic growth was disappointing. The leadership adopted a Sustained Growth Strategy to attain a better result at the end of the 20-year period of U.S. financial assistance under the Amended Compact.

94. While the SDP set the agenda for the Amended Compact, the FSM had already initiated a series of reforms. A major objective of the Compact has been the economic advancement and budgetary self-reliance. However, at the beginning of the original Compact, the policy environment was unconducive to the private sector, inward-oriented, and supported large and growing governments. With the assistance of the ADB through the Public Sector Reform Program (PSRP), a series of reforms was implemented by the FSM state and national governments in the years leading up to the start of the Amended Compact.

95. The FSM, with assistance from the ADB, attempted to maintain the reform effort through implementation of a second ADB-supported initiative called the Private Sector Development Program (PSDP). The PSDP was designed to shift the focus to private-sector development, but it was also intended to solidify the achievements made under the PSRP. The PSDP was approved by the FSM Congress in late in 2000, and subsequent approval and authorizing legislation at the state level was attained a year later. Implementation started in 2003, with the majority of implementation occurring between 2003 and 2006. The ADB closed out the PSDP in February 2007.

96. In March 2012 then president of the FSM created a 2023 Planning Committee, with the objective of addressing likely budgetary shortfalls beyond FY2023when direct sector grant assistance under the Amended Compact terminates. The 2023 Action Plan was unveiled at a meeting of the FSM leadership in Guam on November 4, 2014. The executive summary states that:

> *The 2023 Action Plan is aimed at addressing the fiscal and economic challenges leading up to and post FY2023. It is based around the mutual principals of the Amended Compact, which are to "promote the economic advancement, budgetary self-reliance, and economic self-sufficiency" of the FSM. The Action Plan includes a long-term fiscal reform strategy and a long-term sustainable growth strategy, with the emphasis on private-sector-led growth. The Government's role will be one of facilitation by creating an enabling environment for the private sector to grow.*

97. The following section will examine efforts to reform the public sector and improve the environment for private-sector development. In addition, it will address proposals to reform the tax regime. The chapter closes with an assessment of the major goals of the SDP and Third Economic Summit as well as the potential of the proposed 2023 Action Plan.

A. Public-Sector Reform

1. Public-Sector Payroll

98. At the state-government level, the two states with the most adverse fiscal position, Chuuk and Kosrae, have reduced the size of their workforces significantly and to a lesser extent their wage bill costs. Pohnpei has reduced the size of its workforce and wage bill by equivalent amounts, but Yap, while reducing numbers, has seen a large increase in the wage bill. The average wage cost in Yap state was considerably lower than all of the other FSM governments during the initial Compact, and the recent increases bring Yap in line with wage costs in Chuuk and Kosrae. For the national government, the workforce remains unchanged since the late 1990s, while wage costs have risen significantly. Average wage costs in the national government are twice those in Chuuk, Kosrae, and Yap, and 50 percent higher than in Pohnpei.

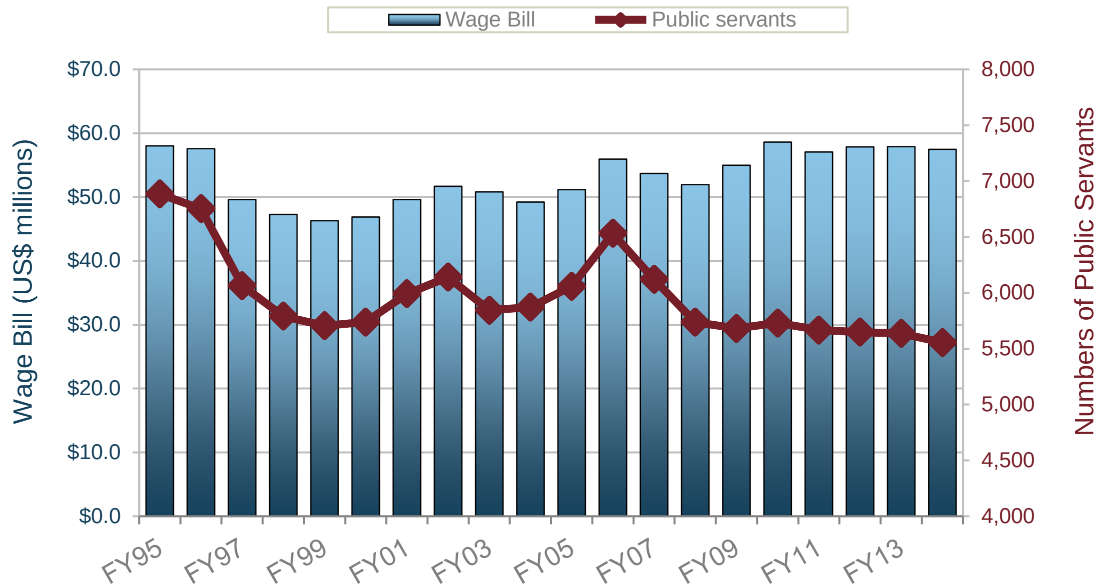

Figure 4.1 FSM government employees and average wage cost, FY1995-FY2014

99. In 2003, the number of government employees rose, reflecting a lack of fiscal discipline in Chuuk (See Figure 4.1). However, since FY2006 numbers have fallen, representing the RIFs in both Chuuk and Kosrae. Wage costs per employee rose during the first seven years of the Amended Compact, by an annual average of 2.3 percent, and although the wage bill fell as the RIFs were implemented, it had risen to pre-reform levels by FY2010. The upward trend in wage costs per employee has flattened and in FY2014 was 1.1 percent higher than in FY2010, and the wage bill has declined by 1.9 percent.

100. During the early period of the Amended Compact, a variety of factors influenced wage costs per employee. This included restructuring the workforce with RIFs in Chuuk and Kosrae; a return to the normal number of working hours in each pay period; upgrading teacher skills; and an award of a cost-of-living adjustment (COLA) in the national and Pohnpei governments. These factors led to an increase in wage costs per employee, although there was a general policy of a wage freeze in most governments. Since FY2010, with domestic fiscal adjustments to the Amended Compact complete, both average wage costs per employee and the wage bill stabilized.

2. Public Expenditure and Financial Accountability

101. In late 2010 the FSM invited the Pacific Financial Technical Assistance Center (PFTAC) to assist the nation in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment for the national government.[5] The framework has six broad categories:

5 The PEFA is a framework for the assessment of public financial management (PFM) developed by the World Bank and a group of international donors in 2005, which has subsequently been updated. It has been implemented in many countries around the world and provides an objective yardstick by which countries can assess and improve their PFM performance. Public Expenditure and Financial Accountability (PEFA) Public

i. Credibility of the budget—the budget is realistic and implemented as intended;
ii. Comprehensiveness and transparency—the budget and fiscal-risk oversight are comprehensive, and fiscal and budget information is accessible to the public;
iii. Policy-based budgeting—the budget is prepared with due regard to government policy;
iv. Predictability and control in budget execution—the budget is implemented in an orderly and predictable manner, and there are arrangements for the exercise of control and stewardship in the use of public funds;
v. Accounting, recording, and reporting—adequate records and information are produced, maintained, and disseminated to meet decision-making control, management, and reporting purposes; and
vi. External scrutiny and audit—arrangements are made for the scrutiny of public finances and follow-up by the executive agents.

102. In 2011 the FSM underwent an external PEFA assessment. A team of assessors, comprised of PFTAC, the World Bank, and members of the national government, assisted by a PEFA expert, completed the assessment. Drawing from the formal assessment, the next step is for the national government to compile a "road map" to identify areas in PFM that are in need of improvement and reform, and help officials focus efforts on the more critical components. The road map would also outline a program of technical assistance, which would be supported by PFTAC. To be a meaningful exercise, a PEFA assessment would need to be undertaken in each of the state-level governments with state improvement programs or road maps developed.

3. Financial Management Information Systems and Performance Management

103. The FSM adopted a strategic approach to implementing the Amended Compact sector grants in the FSM SDP. The approach entailed allocation of public-sector resources, in accordance with detailed matrices of performance criteria to measure both the delivery of services (outputs) and the results (outcomes) attained. However, implementation of the framework has been challenging. While existing budgeting procedures adopted a performance approach and specification of outputs, these were largely hypothetical, as no monitoring or evaluation mechanism had been put in place. As noted by the GAO, there is still a lack of reliable and verifiable data with which to measure outcomes and performance.

104. At the start of the Amended Compact, the FSM inherited a disparate set of financial accounting systems across the five governments. It was evident that the old systems would be unable to support the kind of financial and performance information required under the FPA. Following the implementation of a new financial management information system (FMIS), all five governments were using the same system by FY2008. However, the implementation of the system focused largely on the financial reporting requirements of the Amended Compact, rather than on the fiscal management of the five governments, or performance in service delivery. While the focus on financial and accounting requirements was necessary, the systems fail to

Financial Management Performance Measurement Framework, PEFA Secretariat, Washington D.C., 2011 revised.

provide the type of management information required for fiscal and economic management, or measurement of outputs and outcomes.

105. Development of an Integrated Planning and Budgeting (IPB) software module to interface with the FMIS has been under development within the FSM. If successfully implemented, the system would enable downloading of past financial information into the budgeting process, and uploading of approved budgets back into the FMIS for execution. The IPB module would also utilize direct downloads from the FMIS to enable real-time management and monitoring of budget execution. However, there is no plan to incorporate standard Government Finance Statistics[6] (GFS) as part of the system. Furthermore, the chart of accounts adopted in the existing FMIS fails to provide a coding system of outputs (service delivery). Until the chart of accounts is revised to include output specification and correspondence with GFS, implementation of the IPB will not enable the development of a modern approach to public financial management, as specified in the PEFA.

4. Social Security

Based on an actuarial evaluation completed in January 2012 relating to FY2012[7], Table 4.1 Social Security valuation during 2011-2014 (US$ millions)

	2011	2014
Active Workers Earning Benefits	138.8	128.3
Retirees, Spouses, Children, and Disabled Workers Receiving Benefits	110.4	129.2
Fully or Service Insured Inactive Workers Entitled to a Future Benefit	38.6	50.1
Total Accrued Actuarial Liability	287.8	307.6
Market Value of Assets	-42.4	-49.1
Unfunded Actuarial Accrued Liability	245.4	258.5
Funded Percent	15%	16%

106. Table 4.1 indicates the status of the valuation of the Social Security fund. The accrued liability, regarding active workers, retirees, and other beneficiaries and inactive workers, was $288 million. The value of the assets of the fund was valued at $42 million, indicating an unfunded liability of $245 million. The fund ratio of assets-to-liabilities represented 15 percent. Despite the very low-funded ratio, the FSM fund is better positioned than other similar funds in the region.

107. Effective from Jan. 1, 2013, the law was amended to improve the viability of the fund and adjust the benefits for changes since the last legislative action taken by the FSM Congress. Taxable earnings were raised by $1,000 to $7,000 and are scheduled to rise by $1,000 per quarter every five years until a maximum of $10,000 is reached. The current retirement age of 60 was raised to 65 in October 2015, although those over 60 years may take 50 percent of benefits on reaching 60. Moreover, the FSM Congress has agreed to contribute $2 million per annum to strengthen the viability of the fund.

6 Government Finance Statistics, International Monetary Fund, 2014, Washington D.C.

7 Pacific Actuarial Services, FSM Actuarial Valuation, January 2012

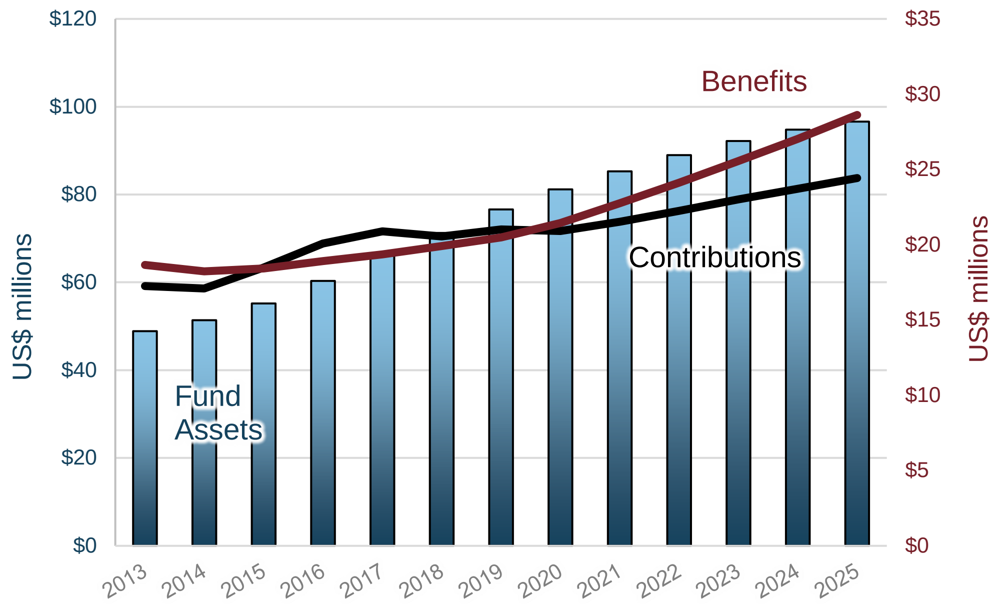

Figure 4.2 Social Security fund balance, contributions, and benefits, FY2013-FY2025

108. A projection of a likely growth of the contributions, benefits, and fund status is shown in Figure 4.3. The estimates for benefits adopts the projections in the actuarial report, while the value of contributions uses the projections of compensation of employees generated in section IV of this review. The annual change in wages is estimated at 2.9 percent, considerably lower than the actuarial assumption of 4.5 percent. A market rate of return of 6.5 percent was adopted, compared with 7.5 percent used in the actuarial report. As Figure 4.3 indicates, projected contributions and benefits are relatively well-balanced in the early years, but after FY2019 benefits are projected to exceed contributions. The difference is made up from earnings on investments and contributions by the FSM government, and the value of the fund is projected to improve. However, the basic excess of benefits over contributions suggests this may not be long-lived. The projections suggest, for example, that without additional contributions from the FSM government, the fund status would max out in FY2022. The projections are, of course, subject to

Table 4.1 Social Security valuation during 2011-2014 (US$ millions)

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Market Value of Assets	-42.4	-49.1
Unfunded Actuarial Accrued Liability	245.4	258.5
Funded Percent	15%	16%

market risk, which may result in a less-favorable outcome.

B. Tax Reform

109. The tax regime in the FSM is based on a tax system inherited from—and largely unaltered since—the time when FSM was part of the Trust Territory of the Pacific Islands. There are three major taxes: wages tax; the business gross-receipts tax; and import duties. Each collects a very similar level of revenue. The tax base has grown by an annual average of 2.6 percent since the beginning of the Amended Compact, less than the rate of nominal GDP of 3.5 percent. This represents an overall buoyancy ratio of 0.75, which indicates the need for tax reform to improve the efficacy of the current regime.

110. In 2002, the FSM held a nationwide tax-and-revenue symposium was held to raise 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 tax 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 of the national and state governments.

111. In 2004, with support from the ADB and PFTAC, the design and structure of a modern tax regime appropriate to the FSM was presented to the FSM leadership for its consideration. The key recommendations included the following:

- 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, which will replace the existing gross-receipts tax (GRT); and
- establishment of a new value-added tax (VAT) to replace import duties and state sales taxes.

112. In September 2005, the reform proposal was put before the Economic Policy Implementation Council (EPIC) and was adopted by resolution. The FSM Congress adopted the reform proposal that same month and asked the president to establish an executive steering committee (ESC). The ESC is responsible 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 from the International Monetary Fund (IMF), for the creation of a Unified Revenue Authority (URA), a new Revenue Administration Act (RAA), and new VAT and NPT laws. At its inaugural meeting in June 2006, the ESC created a technical working group responsible for determining the core tax and administrative policy for the ESC to approve.

113. In April 2007, the ESC convened again and reaffirmed its commitment to the tax-reform initiative. The working group was tasked with preparing a detailed implementation plan and a tax-reform package for submission to each of the FSM states. A tax-reform unit (TRU) was created in late 2007 to manage the reform process. The TRU has been staffed by a project manager and a tax adviser, who was supported and funded through the Australian Agency for

Table 4.3 State and national progress with tax-reform implementation

	URA	RAA	MOU	NPT	Import VAT rate	GRT Repeal	VAT
National	P	Lp	P	R	R	R	
Chuuk		P	P				P
Kosrae		P	P				P
Pohnpei		R	P				R
Yap		R	P				R

Legend
- P-passed
- R-Required
- Not required
- Lp-lapsed

International Development (AusAID).[8] Based on the high-level implementation plan endorsed by the ESC in April 2007, a detailed operational plan for implementing the proposed tax reforms was developed, with the assistance of the PFTAC, in December 2007.

114. Finalization and transmission of the legislation to the FSM Congress was originally planned for July 2008, but these steps were not taken because of several legal issues concerning the constitutionality of the URA legislation at the state level. These issues were resolved by the end of 2009 through amendments acceptable to the states. In March 2010 the president transmitted the set of tax-reform bills to the Congress. After an election in early 2011, the URA was finally approved by Congress and signed into law by the president on April 19, 2012. Congress passed the RAA two weeks later but with a sunset clause, indicating that if the four states had not enacted their components of the reforms, the law would lapse. Operational procedures on the sharing of costs between the national and state governments and the appointment of members to the URA board have been agreed upon through a memorandum of understanding.

At the state level, both Kosrae and Chuuk passed their versions of the RAA and VAT bills in 2012, but neither Pohnpei nor Yap had enacted their requirements. Pohnpei state was resistant to the reforms, and Yap state remained concerned with the potential violation of the state's constitution. To provide more time for the two remaining states to agree on the process, the FSM Congress extended the RAA sunset clause to July 19, 2013, and subsequently to October 2013. This deadline has now passed, and the RAA has lapsed. Table 4.3 State and national progress with tax-reform implementation

8 This position has now been terminated, due to a lack of progress

	URA	RAA	MOU	NPT	Import VAT rate	GRT Repeal	VAT
National	P	Lp	P	R	R	R	
Chuuk		P	P				P
Kosrae		P	P				P
Pohnpei		R	P				R
Yap		R	P				R

Legend
- P-passed
- R-Required
- Not required
- Lp-lapsed

115. Table 4.4Table 4.5 provides a summary of progress.

Table 4.6 Estimated reduction in Amended Compact transfers, FY2014-FY2023, and impact of tax reforms, FY2014 constant prices (US$ millions)

	Real reduction in operational sector grants, FY14-FY23	Tax reform impact FY14	Tax reform % decrement
National	1.1	1.9	166%
Chuuk	4.4	1.7	39%
Kosrae	1.3	0.5	40%
Pohnpei	2.9	5.5	189%
Yap	1.8	2.2	121%
FSM	11.5	11.8	103%

Source: *Kelly Neill: Impacts of Tax Reform in the FSM, 2011*

Table 4.7 Compliance with PSDP policy-reform conditions and overall score (max. 6)

Table 4.6 Estimated reduction in Amended Compact transfers, FY2014-FY2023, and impact of tax reforms, FY2014 constant prices (US$ millions)

	Real reduction in operational sector grants, FY14-FY23	Tax reform impact FY14	Tax reform % decrement
National	1.1	1.9	166%
Chuuk	4.4	1.7	39%
Kosrae	1.3	0.5	40%
Pohnpei	2.9	5.5	189%
Yap	1.8	2.2	121%
FSM	11.5	11.8	103%

Source: *Kelly Neill: Impacts of Tax Reform in the FSM, 2011*

	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**

116. Table 4.8 compares the real reduction in Amended Compact funding over the remainder of the Amended Compact with the tax-reform proposal. At the national level, the estimated impact of the tax reform would be an increase in the tax burden by 4 percent (from 12 to 16 percent of GDP). By international standards this would still leave the FSM as a relatively low-taxed nation. In relation to the annual real reduction in projected sector grants (accounting for the two-thirds inflation adjustment and annual decrement), the reform is sufficient to completely offset the decrease. However, the impact is considerably different by state. Although the results of the reform are greater than the loss of grants in real terms in Pohnpei and Yap, it is not sufficient in Chuuk and Kosrae. The differences in impact are due to the current structure of existing taxes and relative size of the state economies. Unfortunately, the two states that experienced the greatest challenges with the implementation of the Amended Compact are also those that would benefit least under the proposed the tax reforms. This in part reflects the reality that both states have already increased state taxes to maintain present levels of public services.

117. It appeared that the tax-reform process was effectively dead, with the AusAID advisor recalled, and the two remaining states appearing unlikely to proceed. However, in September 2014 President Mori decided to transition the FSM Division of Customs and Tax Administration (CTA) to the URA in FY2015 to keep the tax-reform process alive. Yap state has also requested the ESC to visit the state to re-ignite interest. However, in the May 2015 session, the FSM Congress repealed the URA, thereby halting tax reform. The implications of the inability to enact the reforms are wide-reaching: all future adjustments to reductions in Amended Compact sector grants will have to be achieved through continued expenditure cuts or through increasing rates within the existing outdated, inefficient, and distortionary tax regime. Furthermore, if the FSM is regarded as unable to implement key reforms, donor support may decline.

C. Private-Sector Reforms

1. The Private Sector Development Program

118. The Private Sector Development Program was an ADB-supported initiative structured in two parts: a project and a program loan. The loan contained a series of activities designed to improve the environment and capacity for private-sector development, including reforms to the legal and regulatory environment; increased access to, and security of, land for economic use; better access to finance for small businesses; and improvements to business and entrepreneurial skills. The program loan was disbursed in two parts, and compliance with a series of policy reforms enabled the second tranche drawdown. Only the national and Kosrae state governments

were deemed compliant by the ADB and qualified for the second tranche drawdown. The policy measures entailing both fiscal and private-sector conditions 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 increased Compact assistance, (FY2002 and FY2003);
- 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 (each government).

119. 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 failed to maintain medium-term balance in either one or both FY2003 and FY2004. All governments, except Kosrae, were below their payroll targets as of April 2006. The increased Compact assistance was sterilized by not using it for operations and contributing it to the FSM Trust Fund to meet to $30 million required for the FSM. The FSM has maintained a sound external-debt profile. The following sections discuss in more detail the private-sector components of the program.[9] Discussion of the foreign-investment climate, long-term leasing, and PSE reforms are based on a report prepared for the ADB[10] and a loan closeout report.

i. Foreign Investment Reform

120. The FDI regime in the FSM is highly dependent upon regulations. In each government, the statute sets forth a framework for regulation, leaving much of the detail to be promulgated through 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 attendant timing implications.

121. 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, legislation passed by the Pohnpei state legislature in December 2006 prohibits FDI in many service sectors that compete with local interests. While tourist support services are reserved for local businesses, larger hotels greater than 12 rooms remain open to foreign

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9 See Rick Caldwell, *Legislation for Private Sector Development*, Pohnpei, November 2005, and *Private Sector Development Program Loan - Project Completion Report*, Project Implementation Unit, Department of Economic Affairs, FSM National Government, Palikir, 2007.

10 Legislation for Private Sector Development (November 2005)

investment. As a result of these changes, one dive operation went out of business, and currently Pohnpei state has no operators in this subsector. In Yap state the changes recommended were enacted by the end of 2005. Thus, of the five governments, only the national, Kosrae, and Yap governments implemented the necessary reforms, while these reforms were not achieved in Chuuk and Pohnpei, where the environment for FDI remains adverse.

ii. Land Leasing and Mortgage Reform

122. The FSM constitution prohibits ownership of land by noncitizens. The constitutions of two states—Kosrae and Pohnpei—prohibit ownership 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. The ADB sponsored technical assistance in 1999 to develop the necessary legal framework for a system of long-term land leasing and mortgage reform[11]. The technical assistance 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, so no action was required at the national level.

123. Before commencement of the PSDP, Chuuk was the only state to have adopted legislation related to land. However, there were numerous shortcomings with the legislation, and, although there was no opposition to the proposed changes to bring the FSM's laws into compliance with the requirements under the ADB-sponsored technical assistance, these were not implemented. 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 drawdown, state leadership lost interest. In the case of Yap, 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 drawdown.

iii. Public-Enterprise Reform

124. Much of the groundwork for PSE reform in the FSM was developed with ADB Technical Assistance[12]—referred to as the Aries Report. The final 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 technical assistance 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.

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11 See Rick Caldwell, Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging, Pohnpei, 1999.

12 Project No. 3201-FSM, Privatization of Public Enterprises and Corporate Governance Reform, 2001, Pohnpei.

Table 4.9 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**

125. The first requirement of the PSDP was the transmission of PSE master plans to each government. However, while this objective was achieved, not one master plan was institutionalized or serves 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. 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. In Pohnpei, due to financial considerations the state was forced to sell three fishing vessels to a private company. In Yap the state transferred the television service from a state-owned department to the nationally owned FSM Telecom.

126. 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 one of the 22 major PSEs identified by the FSM in its the SDP. While perhaps qualifying by the letter of the law, the PSDP transformations did not fulfill the intent of the reforms to reduce the size or role of government in the economy. Pohnpei state has subsequently transformed two of its loss-making fisheries enterprises since the closeout 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 been liquidated.

iv. Overall PSD Performance

127. Yap and the national government scored the highest level, fulfilling a majority of the reforms. In the case of Yap, the state did not fulfill the land-reform component and did not complete any significant 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 enacting policies that supported private-sector initiative, but it lacked fiscal discipline and did not make serious efforts to reform its public enterprises. While Pohnpei has generally maintained fiscal discipline, it failed to meet the medium-term fiscal balance requirement, and the environment for private-sector development is

inward-looking. Only recently has the reform of two of its PSEs 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 reforms, rather than a policy decision not to encourage private sector development.

v. The World Bank's 'Doing Business' Survey

128. The World Bank's "Doing Business" survey provides a general assessment of the environment for private-sector development. indicates The FSM's ranking for each of the 10 major categories, which deteriorated in 2013, improved in 2014, but slipped back again in 2015. Overall, the FSM currently scores 148 out of a total of 189 countries, about 80% down the list suggesting that there is much room for improvement. The FSM fairs worse than either of her Micronesian sisters of Palau and the RMI, which rank 136th and 140th, respectively, although not by a large score. In the South Pacific, Papua New Guinea is ranked 145th, Fiji 88th, Vanuatu 94th, Tonga 78nd and Samoa 96th. Overall, the FSM's scores are generally weak. Registering property scores 189 the worst of all countries surveyed by the World Bank, while for protecting investors the FSM comes 185th. Enforcing contracts is also poor at 181. The FSM registers its best score with 53 for trading across borders.

D. Adjustment to the Amended Compact

129. Under the Amended Compact, the FSM was required to implement some fiscal adjustments. First, the switch from 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, and transportation. In the interim, the U.S. agreed that the FSM could was able to 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 five-year period. Those activities that were not listed under the capacity-building grant required immediate adjustment. Moreover, the Amended Compact entailed an 8 percent overall decline in funding, from $83 million to $76 million per annum, and the annual decrement and partial inflation adjustment required long-term fiscal adjustment to the decline in the real level of Amended Compact assistance, amounting to approximately 2 percent per annum. The phase-out of the use of the capacity-building grant for nonconforming activities and decrement-adjustment issues are discussed below.

Table 4.12 FSM's 'ease of doing business' World Bank ranking

Category	2012	2013	2014	2015
Ease of doing business overall rank	140	150	145	148
Starting a business	102	104	151	162
Dealing with construction permits	19	42	37	141
Getting electricity	40	53	30	103
Registering property	183	185	189	189
Getting credit	126	129	61	70
Protecting investors	174	177	186	185
Paying taxes	92	85	114	116
Trading across borders	106	100	106	53
Enforcing contracts	146	149	162	181
Resolving insolvency	164	166	118	116

1. PHASE-OUT OF THE USE OF THE CAPACITY-BUILDING GRANT FOR NONCONFORMING PURPOSES

In FY2005 and FY2006, the phase-out of the use of the capacity-building grant for nonconforming activities was achieved by switching the source of funding of national government operations to domestic revenues and by funding the College of Micronesia out of the education-sector grant. The four state governments were thus largely spared the need for adjustment, although the 30 percent infrastructure requirement and lack of Amended Compact funding for such activities as public works still required significant adjustments, particularly in Kosrae. Table 4.15 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%	28%
Kosrae	92	462	462	2,124	18%	32%
Pohnpei	329	329	329	12,806	3%	7%
Yap	449	449	449	5,672	7%	19%
National				27,316		
FSM	1,753	2,123	2,123	54,907	4%	10%

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

130. Table 4.16 indicates the required adjustments during the subsequent three years of the capacity-building adjustment period (FY2007-FY2009); these fell entirely on the state governments.

i. Pohnpei

131. In Pohnpei, the total adjustment of 7.3 percent of domestic revenues was quite small and was easily absorbed.

ii. Yap

132. In Yap, the 19 percent adjustment, although large, was completed without the need for assistance.

133. In Chuuk and Kosrae, however, the adjustment was both sizable and unavoidable

iii. Kosrae

134. In Kosrae, the adjustment amounted to 32 percent of domestic revenues and required

Table 4.15 Capacity-building-sector transition and Compact fiscal adjustment

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

implementation of a fiscal adjustment program. The imminent and dire implications of not responding to the need for fiscal adjustment before FY2008 compelled Kosrae's 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, which were achieved through: (i) expenditure reduction; (ii) enhanced revenue effort; and (iii) measures to mitigate the impact of the adjustment.

135. Expenditure reduction focused on the elimination of 110 positions from the FY2008 budget, which involved cutting 76 positions and 34 vacant jobs, with a total planned cost savings of $874,000. Expenditure reduction included a further $270,000 in a 5 percent, across-the-board pay cut and $200,000 in nonpayroll cost reductions. Revenue efforts included tax increases yielding $500,000. The results of the shifts in both revenue and expenditures totaled $1,844,000, with $293,000 remaining to be accomplished in the FY2009 budget. Measures to mitigate the impact of the RIF included a one-year salary payout, with proposed U.S. support by way of Amended Compact sector-grant funding. This mitigation measure was augmented in kind by grant assistance from the People's Republic of China.

iv. Chuuk

136. While Kosrae was able to make a timely and sizable adjustment in response to the fiscal challenge, Chuuk took considerably longer to adjust. In Chuuk the adjustment amounted to 28 percent of domestic revenues and required implementation of a fiscal-adjustment program.

137. By November 2007, the state's fiscal position had deteriorated significantly, and Chuuk's leaders convened a conference to adopt more comprehensive adjustment measures. The adjustment program in Chuuk was similar to that of in Kosrae, and a target of $3.36 million was to be reached through expenditure compression and revenue enhancements. The magnitude of the adjustment reflected a need to remove eliminate the deficit ($1.97 million) and create a sustained surplus ($1.5 million), in order to address the state's problem of outstanding debt. The leadership committed to personnel reductions of over 375 positions, with a one-year payment financed by Amended Compact sector-grant assistance. An additional $200,000 of nonpayroll, general-fund expenditure cuts was identified, and revenue-raising measures yielded $600,000.

138. During FY2008, 317 public servants were part of the RIF, with annual cost savings of $1.9 million. While additional revenue measures were identified, these have been restricted to enhancing revenue collection, rather than increasing tax rates. The impact of the program has been to return the state to fiscal balance, but the objective of building a sustained surplus to pay down state debt has not been achieved.

2. Decrement Management

139. The accumulated reduction in the real value of Compact sector grants is an annual average decline of 2 percent. This represents a real resource loss of 5 percent of the projected value of GDP in FY2013. The Amended Compact was specifically designed to avoid the large impact of each five-year decrement of funding under the original Compact and thus ease the process of adjustment. However, the relatively small adjustment of 2 percent per annum cannot

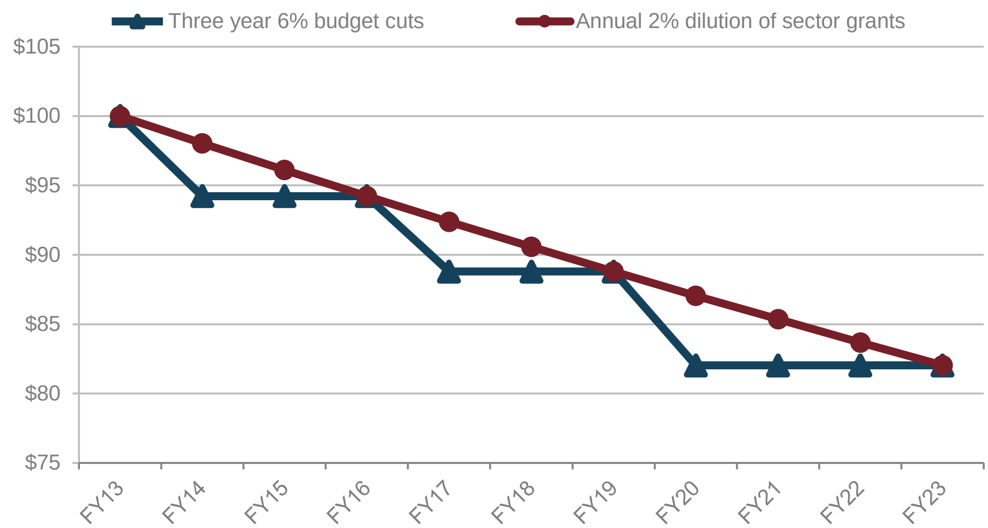

Figure 4.4 LTFF three-year adjustment cycles, constant prices (US$ millions)

be easily achieved year to year on a long-term basis, without distorting the delivery of public services or the cost structure of government. Recognizing the impact of the annual real decline of Amended Compact funds, the JEMCO called for the FSM to develop a plan for managing annual decreases in direct assistance under the Amended Compact and to subsequently use that plan as a basis for budget decisions. After a subsequent resolution was adopted in 2010, The FSM began preparation of a long-term fiscal framework (LTFF), and convened a National Economic Symposium (NES). The LTFF was prepared by the Office of Statistics, Budget and Economic Management, Overseas Development Assistance, and Compact Management (SBOC). The NES was convened in February 2011 and was widely attended, with the participation of the FSM leadership. Four resolutions were endorsed by the NES, including adoption of the LTFF, which was to be returned to the states for their endorsement.

140. However, the states did not endorse the LTFF. At the FY2012 JEMCO meeting, the states indicated that the national government's LTFF had been drafted without adequate state-level consultations and did not reflect their priorities or needs. In the absence of a credible LTFF, a new process was initiated with the prime intention of ensuring that the final product or LTFF had state-level participation and reflected local priorities.

141. A round of state leadership meetings was accordingly convened. Each state was informed that the annual decrement and two-thirds inflation adjustment amounted to a 20 percent cut in the real value of sector grants over the FY2013-FY2023 period: approximately 2 percent per annum. The initial task fell to each state to prepare budgets as if the 20 percent reduction would be effective from FY2014. The leadership meetings were required to prioritize the budgets prepared by each department/agency, ranking the order of the cuts from highest to lowest priority. However, it was not intended that the 20 percent cut would take place immediately in FY2014, but rather in a set of three tranches of 6 percent each over a three-year period (see Figure 4.5). Each state was then requested to identify the initial three-year cut of 6 percent, which would be a firm commitment and reflected in the FY2014 budgets submitted to the JEMCO.

142. It was envisioned that this process would be repeated in three-year intervals. Identification of specific budgets and priorities over a 10-year horizon was not realistic, as many factors would be subject to change. Reassessment and prioritization over a three-year, medium-term horizon was considered more appropriate.

143. The intended LTFF provides for some inflation adjustment in the intervening years. Since the Amended Compact provides for a two-thirds inflation adjustment, the nominal value of the annual sector grants remains relatively static: the annual decrement is essentially offset by the inflation adjustment.

144. In June 2012, Kosrae state was the first to complete the process with leadership endorsement. Yap state followed in July, and Chuuk undertook the process in August, with Pohnpei following in January 2013. The LTFFs prepared by the states formed the basis of the FY2014 budget requests presented to the JEMCO. No formal review of the efficiency of the LTFF process in addressing the decrement issue has been undertaken. The process provided a participatory approach to prioritizing expenditures in a comprehensive way. The LTFF will need to be repeated in FY2017. At that time, areas for further cuts will be difficult to identify and consolidation will require some hard decisions.

145. While the FSM states completed their LTFFs, the national government argued that a national LTFF was not required, since it faced completely different fiscal circumstances. However, sharing of national revenues could dramatically reduce the burden of the decrement at the state level. However, the national government has not yet effectively addressed this critical issue.

146. For FY2014, no allocation for Amended Compact sector grants was made to the national government, with the exception of the continuing operational grants to the College of Micronesia (COM). This is programmed to decline by $700,000 a year until reaching $1 million. This decision increases the amount of Amended Compact sector grants that can be applied at the state level, and could obviate the need for the second round of LTFF decrement planning. However, a third round of LTFF planning will still be necessary.

E. Planning Initiatives

1. The Third FSM Economic Summit

147. The Third FSM Economic Summit was held in Palikir, Pohnpei, from March 29 to April 2, 2004. The summit included presentations of three economic scenarios that the FSM might experience between FY2004 and FY2023: 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, the discussion focused primarily on the moderate-growth and sustained-growth scenarios. The summit adopted a six-part strategy for transition and accelerated growth, which included:

- establishing macroeconomic stability;
- promoting good governance—improving effectiveness and efficiency of government;
- developing an outward-oriented, private-sector-led economy;

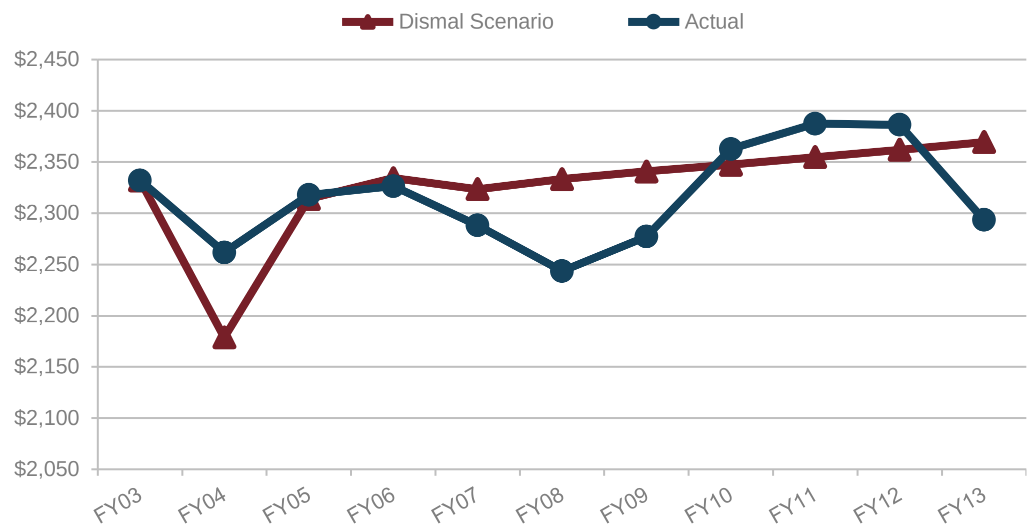

Figure 4.8 Comparison of the Third Summit 'dismal scenario' with performance, GDP per capita, 1998 prices (US$)

- investing in human-resource development;
- investing in infrastructure; and
- creating long-term sustainability.

148. The FSM SDP examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns (Figure 4.7). Figure 4.9 compares the projected dismal scenario with the actual performance since FY2003. In the initial years of the Amended Compact through FY2009, economic performance was indeed dismal, as the economy adjusted to the new provisions—a long painful period that had not been envisioned. In the next three years, the economy was on a higher trajectory. However, in FY2013 with the reduction in FAA projects, and management issues with the use of the infrastructure sector grant, the

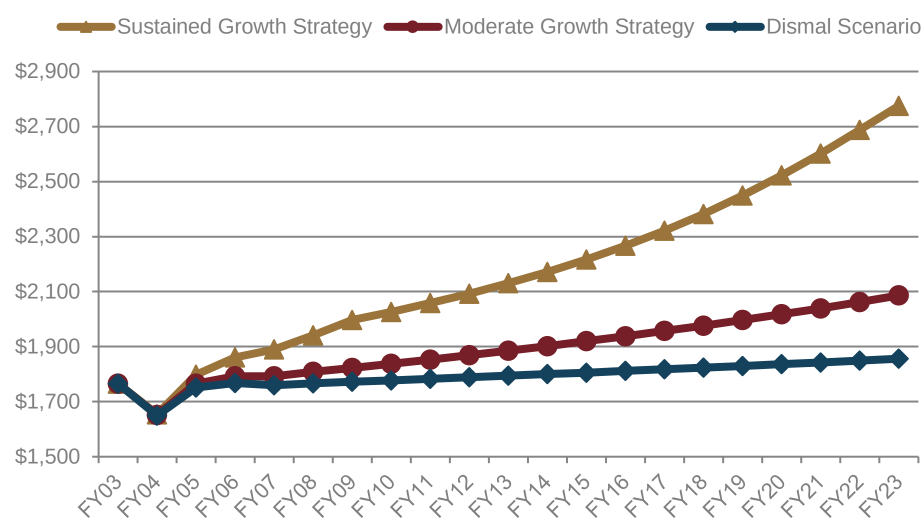

Figure 4.6 Alternative growth scenarios, GDP per capita, 1998 prices (US$)

economy once again dipped below the dismal scenario. The FSM has not adopted a robust reform agenda, and the outcome has been the "dismal" scenario outlined at the summit.

2. The 2023 Action Plan

149. As the lack of economic growth during the first 10 years of the Amended Compact has become apparent, and with concerns related to the Compact Trust Fund, the leadership of the FSM is looking at reforms o better position the nation after FY2023. In March 2012, the president of the FSM established the 2023 Planning Committee through Executive Order No. 40, which states:

> *The primary mandates of the Task Force are as follows: (1) undertake assessment of the nature and magnitude of the financial situation of the FSM Governments in 2024 onwards and identify the expected budgetary shortfalls; (2) explore different alternative and funding scenarios for addressing the projected budgetary shortfall; (3) develop and present to the leadership a realistic and credible action plan for addressing the looming financial shortfall in 2024 and beyond; and (4) others as may be necessary to complete its task.*

150. With support from the ADB, a draft 2023 Action Plan was prepared and unveiled in November 2014. The main focus of the plan includes:

- Contribution of $15 million a year to an investment development fund (IDF);
- Contribution of $10 million a year to an FSM Trust Fund;
- Implementation of the FSM-wide, tax-reform initiative;
- Implementation of the backlog ($126 million) of Compact infrastructure sector grants;
- Maintenance of real government expenditure growth at 2 percent per annum;
- Regulatory reforms to the FSM private-sector environment with assistance from the IFC—World Bank; and
- A series of sector specific policies—agriculture, fisheries, tourism, energy, and information and communication technology.

151. Like the SDP, the Action Plan indicates that a significant improvement in economic growth could be realized through implementation of policy reforms. The Action Plan estimates that implementation would lift the rate of growth to 2 percent per annum, slightly less than the sustained-growth strategy proposed to the FSM leadership at the Third FSM Economic Summit. With the exception of the large annual contributions to the IDF, most of the proposals are very similar to those proposed in the 2005 SDP.

152. However, improvements to the policy environment have been hard to achieve. Implementation of the FSM tax reforms has been stalled for 10 years, the FSM has been unable to professionally organize itself to fulfill the conditions required to release the backlog of infrastructure sector grants. Although, some success has been made to improve the environment for the private sector, the FSM's ranking in the World Bank's "ease of doing business" report indicates that more reforms are needed.

153. Like the SDP, the Action Plan indicates that a significant improvement in economic growth could be realized through implementation of the policy reforms. The Action Plan proposes that government expenditures also grow at 2 percent per annum, to offset the annual decrement and lack the two-thirds inflation adjustment and prevent the erosion of the real level of government services. However, this the Action Plan assumes that the reforms will be implemented, including the tax reform and release of the infrastructure sector grant. If reforms are not implemented, the rate of economic growth will likely be similar to the “dismal” scenario.

F. Conclusion

Table 4.18 Summary of FSM policy reforms

	Achievement	Score
Fiscal policy		
Fiscal balance	Fragile, balance achieved since FY2007	
Public-sector payroll	Size of public service reduced through amended Compact; wages grew at start, but held in check since FY2010	
External debt	Sound external-debt position	
Long-term fiscal adjustment	Initial adjustment to Amended Compact achieved in Chuuk and Kosrae; long-term fiscal frameworks prepared in all states to address decrement management	
Social Security	Reforms enacted and unfunded liability moving in direction of sustainability	
Macroeconomic Monitoring	Full set of statistics available for economic performance assessment	
Public Financial Management		
Public Expenditure & Financial Accountability (PEFA)	External assessment completed; no implmentation road map executed; not rolled out to the states	
Financial accountability	Audits currently "unqualified"	
Strategic Development Plan	Completed at outset of Amended Compact; monitoring and implementation underresourced; draft 2023 Plan attempts to revitalize key components	
Medium-term fiscal framework	Not currently adopted in the FSM	
Performance management	Weak and no monitoring of outputs or outcomes	
Information systems	Captures financial information only	
State-Owned Enterprises		
Subsidies	Less than 0.5 percent of GDP	
Divestment	Fisheries coporations either defunct or under private management/ownership	
Full-cost recovery	Utilties operate on cash-flow basis, without setting aside funds for depreciation	
SOE policy	No national or state-level SOE policy framework	
Tax Reform	No progress after many years of active consideration; tax reform laws repealed by FSM Congress	
Regulatory Environment		
FDI	Reforms in late 1990s, but further improvements needed	
Land reform	Some progress, but considerably more required	
"Doing Business Survey"	World Bank survey places FSM 145th out of 189	

154. Table 5.1Table 5.2 provides a selected summary of various components of the FSM’s policy and institutional structure that have been part of the reform agenda and have been discussed in this review.

155. ***Fiscal Policy:*** At the start of the Amended Compact, the FSM was faced with the issue of restructuring departmental expenditures to better meet changes resulting from the Amended Compact. After a period of adjustment and execution of RIFs in Chuuk and Kosrae, fiscal balance has been achieved in all states since FY2007, although balance is finely tuned. Public-

sector employment has fallen, with the need to reduce expenditures outside the sector-grant areas. However, wages rose in the early part of the Amended Compact, reflecting the restructuring, annual wage drift, and payment of a COLA. Since FY2010, public-sector wages costs have been held in check, with modest annual increases. The FSM has adopted a favorable external-debt strategy, reflected in a low debt-to-GDP ratio, and this poses no significant risk. Long-term fiscal management has entailed both the initial and painful downsizing in Chuuk and Kosrae and the need for decrement management. Each state has prepared a long-term fiscal framework (LTFF) to enable an efficient adjustment to the annual decrements in real Compact funding levels. The Social Security system has been modified to meet the deteriorating unfounded liability of the mid-2000s. With adjustments to tax rates, thresholds, and retirement provisions, the Social Security fund is now moving toward sustainability.

156. ***Macroeconomic Monitoring:*** At the start of the Amended Compact, the FSM had a limited set of basic macroeconomic statistics available upon which to assess economic performance. Since that time, with the support of U.S. technical assistance, the FSM has a full set of the major economic statistics, which include: GDP, employment, wage data, CPI, banking statistics, balance of payments, international investment position, external debt, and government fiscal statistics. Local capacity is improving, and capacity building is supported by international donors.

Table 4.18 Summary of FSM policy reforms

	Achievement
Fiscal policy	
Fiscal balance	Fragile, balance achieved since FY2007
Public-sector payroll	Size of public service reduced through amended Compact; wages grew at start, but held in check since FY2010
External debt	Sound external-debt position
Long-term fiscal adjustment	Initial adjustment to Amended Compact achieved in Chuuk and Kosrae; long-term fiscal frameworks prepared in all states to address decrement management
Social Security	Reforms enacted and unfunded liability moving in direction of sustainability
Macroeconomic Monitoring	Full set of statistics available for economic performance assessment
Public Financial Management	
Public Expenditure & Financial Accountability (PEFA)	External assessment completed; no implmentation road map executed; not rolled out to the states
Financial accountability	Audits currently "unqualified"
Strategic Development Plan	Completed at outset of Amended Compact; monitoring and implementation underresourced; draft 2023 Plan attempts to revitalize key components
Medium-term fiscal framework	Not currently adopted in the FSM
Performance management	Weak and no monitoring of outputs or outcomes
Information systems	Captures financial information only
State-Owned Enterprises	
Subsidies	Less than 0.5 percent of GDP
Divestment	Fisheries coporations either defunct or under private management/ownership
Full-cost recovery	Utilties operate on cash-flow basis, without setting aside funds for depreciation
SOE policy	No national or state-level SOE policy framework
Tax Reform	No progress after many years of active consideration; tax reform laws repealed by FSM Congress
Regulatory Environment	
FDI	Reforms in late 1990s, but further improvements needed
Land reform	Some progress, but considerably more required
"Doing Business Survey"	World Bank survey places FSM 145th out of 189

157. ***Public Financial Management (PFM):*** The FSM initiated a program to adopt the World Bank and IMF standard Public Expenditure and Financial Accountability (PEFA) as a means to improving PFM. However, after an external assessment was made at the national-government level, no further progress has been achieved. In the area of financial accountability and control, all audits are no longer qualified, and the national and state finance offices are generally adequately staffed. At the onset of the Amended Compact, the FSM prepared a SDP, which was required to inform budget planning and implementation. The SDP was a quantitative document and provided a series of matrices, with output- and results-orientated indicators. Although it has been 10 years since the SDP was published, the majority of the material in the plan remains relevant. In late 2014, the FSM issued a draft 2023 Action Plan, designed to prepare the nation for the end of U.S. financial assistance under the Amended Compact and reinvigorate parts of the reform agenda. The FSM has not adopted the standard approach, or medium-term fiscal framework (MTFF), for budget management. Although performance budgets (the expenditure framework) have been prepared, they are not monitored or audited. As a result, there is no effective performance management. Both the MTFF and performance management items are coded red. Financial management information systems (FMIS) provide adequate accounting and audit data, but they do not provide a basis for measuring output delivery, fiscal statistics, or budgeting.

158. ***State-Owned Enterprises (SOEs):*** The level of SOE subsidy in the FSM is less than 5 percent of GDP, and the nation has avoided the financial pitfall experienced in many countries. The SOE sector has undergone consolidation, with liquidation or sale of the large fisheries investments to private management. However, other public entities would benefit from more efficient and effective management. The utility services are run as state monopolies, at less than full-cost recovery. Performance has been weak, with frequent power outages, due to lack of maintenance and underpricing. Chuuk state is the one exception, with now-reformed management, after receiving Compact sector grant support. An ADB technical assistance program was executed in the early 2000s to rationalize and transform the sector, although no sector-wide SOE policy framework was proposed.

159. ***Tax Reform:*** In the early 2000s an ambitious tax-reform program was proposed and adopted by the FSM, requiring action and coordination at both the national and state levels. After many years of activity, two states—Pohnpei and Yap—dropped out of the program, and the FSM Congress has repealed the tax-reform legislation. Efforts from advocates and donors has not borne fruit in this area.

160. ***Private-Sector Regulatory Environment:*** An attempt to rationalize the regulatory environment for foreign investment was adopted in the early 2000s, demarking the division between the national and state levels. However, while laws were enacted and the system put in place, Pohnpei opted to maintain a Foreign Investment Board, as did Yap state, in response to large-scale investment interest in tourism. During the Amended Compact, the FSM has failed to attract any significant foreign investment. As part of the ADB private-sector development program, legislation for long-term leasing of land was prepared to encourage development and mortgage-secured commercial lending. Only one state enacted the legislation. The World Bank's "Doing Business" survey ranks the FSM 145th out of 189 countries, with a rank of 186 for protecting investors.

161. Overall, the policy, regulatory, and institutional environment needs further reforms, if the FSM is to be transformed into a growing economy, as envisaged in the earlier SDP or the current 2023 Action Plan. Economic performance during the first 10 years of the Amended Compact has been poor, with weak implementation of the stated reform agenda. Much attention during the first 10 years was in adjustment to the sector-grant approach and subsequently in the decrement-management issue. For economic growth and development to accelerate, the reform agenda needs to pick up momentum to establish an environment conducive to achieving the goals of the Amended Compact.

V. The Use and Effectiveness of United States Financial Assistance

162. In compliance with the terms of the five-year review, this section reports on "the use and effectiveness of United States financial, program, and technical assistance." To a large extent, this task was addressed in a comprehensive GAO report[13] issued in 2013 based on expenditures during the initial nine years of the Amended Compact. While the study focused on expenditures in the health and education sectors only, the findings and conclusions of the report remain relevant.

163. Through its participation in the JEMCO, the United States can require that terms and conditions be attached to any and all annual grant awards to improve program performance and fiscal accountability. JEMCO resolutions have primarily addressed the need for the FSM to address the annual decrements in compact funding and the impact upon education and health programs and services. For information on JEMCO resolutions, see appendix XX.

164. The FSM has dedicated 82 percent of its non-infrastructure Compact expenditures to the education (48 percent) and health (34 percent) sectors. The FSM spent significant amounts of Compact assistance on personnel and recurrent operating expenditures in all sectors in lieu of programmatic expenditures.

165. An important conclusion of the GAO report was that: "because of data reliability issues [the FSM cannot] demonstrate whether it has made progress toward its goals in [the education and health] sectors." This review, coming on the heels of the GAO report, does not dispute the basic conclusion that data reliability (and validity) issues must be addressed in order to accurately report on the effectiveness of Compact assistance. As such, this review limits its coverage to the use of funds over the 10-year period. Recommendation No. 5 of this review targets the mandate of measuring Compact grant effectiveness. Recommendation No. 6 of this review addresses improving FSM compliance and accountability in a manner designed to be fully responsive to the GAO's conclusions and recommendations.

166. Table 5.1 FSM's operating-sector grant, annual expenditures (US$ millions)

[13] See GAO, *Compacts of Free Association: Micronesia and the Marshall Islands Continue to Face Challenges Measuring Progress and Ensuring Accountability*, GAO-13-675 (Washington, D.C.: September 2013).

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
FSM-WIDE TOTAL	**52.700**	**56.588**	**54.469**	**49.962**	**56.737**	**55.243**	**53.582**	**60.732**	**55.176**	**54.143**	**549.333**
National	9.308	6.386	4.722	5.478	5.546	5.357	5.288	5.231	5.339	4.559	57.215
Chuuk	15.840	18.692	18.328	17.576	21.476	19.514	19.992	25.373	19.858	21.055	197.705
Kosrae	5.102	5.999	6.354	5.503	6.120	6.379	5.982	6.132	6.559	6.093	60.223
Pohnpei	15.043	15.785	14.810	13.487	14.762	14.651	13.927	14.788	14.649	13.912	145.814
Yap	7.408	9.725	10.256	7.917	8.834	9.342	8.392	9.207	8.772	8.524	88.377

167. Table 5.2Table 5.1 shows the recorded total expenditures for all of the operating sectors in the Amended Compact. Total operating-sector grant expenditures over the period were $549 million.

168. The FSM has tracked 20 indicators selected by the Government of the FSM for measuring progress (see appendix XX for a list of FSM’s education indicators). The FSM’s overarching education goals were to improve the educational system of the country including primary, secondary, and postsecondary education, and to develop the country's human and material resources necessary to deliver these services. The GAO found problems with data reliability in FSM education indicators.[14] In the annual education indicators report that it submitted to JEMCO from 2007-2011, the FSM identified problems with overall quality, and consistency of the education data, as well as problems with timeliness in reporting. Additionally, the reports noted the need for training of the data managers and difficulties with the data systems. In March 2012, JEMCO reaffirmed the need for reliable education data to evaluate performance in a resolution that required independent verification of performance indicators and data for education sector which the FSM was to communicate in a report due to OIA by July 1, 2013, prior to the August 2013 annual meeting.

169. The FSM established 14 indicators to measure progress toward its goal of improving primary health care in the FSM in 2004 (see appendix XX for a list of the FSM's health indicators), according to the FSM Department of Health Services and Social Affairs (HESA). The FSM reported on its indicators in a July 2012 report by the FSM National Department of HESA covering fiscal years 2004 through 2011. The report noted limitations with the data. JEMCO noted concerns regarding the reliability of data reported for the health indicators. In a 2012 resolution JEMCO reaffirmed the need for reliable quantifiable health data to evaluate performance and also required independent verification of performance indicators and data for the health sector; it required the FSM to submit a report on the health indicators by July 1, 2013. The FSM has since taken no discernible action to comply with this unanimously adopted resolution.

[14] Ibid.

170. Private Sector Development Sector, Environment Sector, and Public Sector Capacity Building Grants have almost exclusively supported recurrent operating expenditures for state government departments, agencies and offices without programmatic linkage to achievement of any stated strategic goals or outcomes.

171. The trends across the two largest sectors—education and health—are shown in Table 5.2 FSM's education- and health-sector grants, annual expenditures (US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
EDUCATION	**24.283**	**25.844**	**26.084**	**25.873**	**27.645**	**27.413**	**28.215**	**28.103**	**25.970**	**26.423**	**265.854**
National	4.315	4.476	4.162	4.345	4.372	4.397	4.362	4.345	4.312	3.601	42.687
Chuuk	7.384	8.248	8.216	8.233	8.547	8.882	10.047	9.623	7.989	9.545	86.715
Kosrae	1.884	2.070	2.358	2.239	2.223	2.406	2.514	2.429	2.480	2.427	23.031
Pohnpei	7.140	7.002	7.143	7.066	8.031	7.626	7.242	7.684	7.457	7.190	73.580
Yap	3.560	4.047	4.205	3.990	4.473	4.103	4.050	4.023	3.732	3.660	39.842
HEALTH	**13.292**	**16.752**	**16.669**	**16.330**	**18.643**	**21.515**	**19.882**	**21.238**	**21.793**	**20.283**	**186.399**
National	0.491	0.720	0.560	0.766	0.721	0.548	0.622	0.597	0.782	0.809	6.617
Chuuk	4.303	5.485	5.721	6.233	7.652	8.994	8.175	8.860	9.069	8.494	72.987
Kosrae	1.327	1.647	1.697	1.733	1.982	2.424	2.184	2.121	2.218	2.109	19.440
Pohnpei	5.350	6.037	5.281	4.645	5.491	6.149	5.952	6.137	6.217	5.661	56.920
Yap	1.822	2.863	3.411	2.953	2.797	3.399	2.949	3.523	3.507	3.210	30.435

172. Table 5.3Table 5.4. Expenditures ramp up in education through FY2010, and in health through FY2009. The modest downturn in the latter period is a result of the structure of the Amended Compact, specifically the decrement of sector-grant funding by $800,000 annually. It

Table 5.1 FSM's operating-sector grant, annual expenditures (US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
FSM-WIDE TOTAL	**52.700**	**56.588**	**54.469**	**49.962**	**56.737**	**55.243**	**53.582**	**60.732**	**55.176**	**54.143**	**549.333**
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Table 5.2 FSM's education- and health-sector grants, annual expenditures (US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
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Pohnpei	7.140	7.002	7.143	7.066	8.031	7.626	7.242	7.684	7.457	7.190	73.580
Yap	3.560	4.047	4.205	3.990	4.473	4.103	4.050	4.023	3.732	3.660	39.842
HEALTH	**13.292**	**16.752**	**16.669**	**16.330**	**18.643**	**21.515**	**19.882**	**21.238**	**21.793**	**20.283**	**186.399**
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Yap	1.822	2.863	3.411	2.953	2.797	3.399	2.949	3.523	3.507	3.210	30.435

should be noted that one conclusion of the GAO report, that the FSM "must complete plans that address annual decrements in Compact funding," was achieved by the end of the period (effective FY2014) through the development of LTFFs by each of the four state governments and integration into their annual budgets. Those plans protect, to an extent, the social sectors from the full effect of the decrement through reductions in allocations to other Compact operating sectors and the allocation, where available, of some local revenues.

173. The other Compact operating sector grants (Table 5.5 FSM's other operating-sector

Table 5.5 FSM's other operating-sector grants, total annual expenditures (US$ millions))

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
Other Sectors	**10.326**	**8.055**	**5.603**	**4.377**	**7.161**	**2.677**	**2.227**	**7.423**	**2.335**	**2.354**	**93.235**
National	4.503	1.190	0.000	0.368	0.453	0.412	0.304	0.290	0.245		7.763
Chuuk	4.153	4.959	4.390	3.111	5.277	1.638	1.770	6.890	2.799	1.094	36.082
Kosrae	1.891	2.282	2.300	1.530	1.915	1.549	1.284	1.582	1.861	0.422	16.616
Pohnpei	2.552	2.747	2.386	1.777	1.240	0.876	0.734	0.967	0.975	0.421	14.674
Yap	2.026	2.814	2.640	0.974	1.564	1.841	1.393	1.662	1.533	1.654	18.099

grants, total annual expenditures (US$ millions))

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
Other Sectors	**10.326**	**8.055**	**5.603**	**4.377**	**7.161**	**2.677**	**2.227**	**7.423**	**2.335**	**2.354**	**93.235**
National	4.503	1.190	0.000	0.368	0.453	0.412	0.304	0.290	0.245		7.763
Chuuk	4.153	4.959	4.390	3.111	5.277	1.638	1.770	6.890	2.799	1.094	36.082
Kosrae	1.891	2.282	2.300	1.530	1.915	1.549	1.284	1.582	1.861	0.422	16.616
Pohnpei	2.552	2.747	2.386	1.777	1.240	0.876	0.734	0.967	0.975	0.421	14.674
Yap	2.026	2.814	2.640	0.974	1.564	1.841	1.393	1.662	1.533	1.654	18.099

174. Table 5.6Table 5.7) have absorbed approximately 17 percent of total operating grant expenditures. In order, they include: the public-sector, capacity-building sector (9.6 percent); private-sector development (4.8 percent); environment (3 percent); and enhanced reporting and accountability (0.4 percent). The latter sector was created by mutual agreement of the governments and was available for use only during the final two years of the period under review. As noted above, there has been a general trend across the governments of the FSM to reduce request levels for allocations to the smaller sectors as a means of protecting the priority education and health sectors, in part, from the annual decrement.

175. The public-sector infrastructure grant, which is available for allocation of not less than 30 percent of annual grant totals, has not been utilized at a reasonable pace over the course of the period under review. Using the total available funding from the Compact during the 10-year period being reviewed, Table 5.8 FSM sector-grant annual, unexpended amounts (net carryover, US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
FSM	**6.181**	**2.786**	**1.045**	**6.194**	**-0.189**	**1.692**	**2.953**	**-4.299**	**1.342**	**2.879**	**20.584**
National	0.450	-0.338	0.080	0.137	0.109	0.336	0.365	0.412	0.312	1.143	3.008
Chuuk	1.563	0.856	3.084	3.763	0.013	2.121	1.491	-3.928	1.620	0.613	11.195
Kosrae	0.221	0.213	-0.214	0.618	0.044	-0.173	0.180	0.019	-0.398	0.122	0.632
Pohnpei	1.189	0.933	-0.548	0.726	-0.450	-0.241	0.382	-0.505	-0.344	0.520	1.663
Yap	2.758	1.122	-1.357	0.950	0.095	-0.352	0.535	-0.297	0.153	0.480	4.087

176. Table 5.9 below shows that $228.835 million was made available for spending on public-sector infrastructure. This represents 29 percent of the total Compact sector-grant funding available ($798.752 million). The reason the amount is slightly below 30 percent is that the requirement for 30 percent allocation was not established by the JEMCO until FY2006.

177. The inability of the FSM to fully utilize the infrastructure-grant stream in a timely manner is best summarized in the following combination of persistent problems: (i) most important, the unwillingness to equip the FSM project management unit (PMU) with the quality and quantity of professional staff needed, including program and construction managers and engineers; (ii) an inability to coordinate submissions from the five governments consistent with the FSM's Infrastructure Development Plan (IDP) and consistent with explicit Compact priorities on health, education, and sanitation infrastructure; and (iii) during the latter period, an unwillingness to update the IDP until after the period under review. As noted in section IV above, the failure to utilize infrastructure funding on a timely basis has created a significant drag on economic growth over the whole period. Looking forward, and assuming the FSM follows clear guidance to accelerate funding approvals through the JEMCO and implementation of projects on the ground in the four states, there is an opportunity for commensurately accelerated economic growth outcomes in the medium term. Notably, this review makes no recommendations to address the problem of infrastructure under-expenditures, simply because the causes and cures are fully articulated, well (if not widely) understood in the government of the FSM, and, with sufficient resource allocations, eminently achievable in the near-to-medium term.

178. Table 5.8 FSM sector-grant annual, unexpended amounts (net carryover, US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
FSM	**6.181**	**2.786**	**1.045**	**6.194**	**-0.189**	**1.692**	**2.953**	**-4.299**	**1.342**	**2.879**	**20.584**
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Chuuk	1.563	0.856	3.084	3.763	0.013	2.121	1.491	-3.928	1.620	0.613	11.195
Kosrae	0.221	0.213	-0.214	0.618	0.044	-0.173	0.180	0.019	-0.398	0.122	0.632
Pohnpei	1.189	0.933	-0.548	0.726	-0.450	-0.241	0.382	-0.505	-0.344	0.520	1.663
Yap	2.758	1.122	-1.357	0.950	0.095	-0.352	0.535	-0.297	0.153	0.480	4.087

179. Table 5.9 indicates the level of annual grants that remained unexpended at the end of each fiscal year through the period under review. For the FSM, this issue has been particularly problematic at times, and for the whole period, for at least one state government (Chuuk). At the end of the period under review, fully $20.584 million was recorded as unexpended (carry over), with more than half of that resulting from under-spending by the state of Chuuk. Perhaps notably, that level was virtually unchanged from the end of the seventh year of the Amended Compact, so the problem was not growing toward the end of the period.

180. Under the terms of the Amended Compact, the unexpended funds do not lapse, but they do return to the U.S. Treasury for awards in subsequent years. In general, the programming (or reprogramming) of such carryover funds has been channeled toward nonrecurrent uses—under JEMCO adopted guidelines—so as to not exacerbate problems related to decrement management and not increase recurrent spending, in light of anticipated adjustment problems after FY2023,

Table 5.8 FSM sector-grant annual, unexpended amounts (net carryover, US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	Sum
FSM	**6.181**	**2.786**	**1.045**	**6.194**	**-0.189**	**1.692**	**2.953**	**-4.299**	**1.342**	**2.879**	**20.584**
National	0.450	-0.338	0.080	0.137	0.109	0.336	0.365	0.412	0.312	1.143	3.008
Chuuk	1.563	0.856	3.084	3.763	0.013	2.121	1.491	-3.928	1.620	0.613	11.195
Kosrae	0.221	0.213	-0.214	0.618	0.044	-0.173	0.180	0.019	-0.398	0.122	0.632
Pohnpei	1.189	0.933	-0.548	0.726	-0.450	-0.241	0.382	-0.505	-0.344	0.520	1.663
Yap	2.758	1.122	-1.357	0.950	0.095	-0.352	0.535	-0.297	0.153	0.480	4.087

when the FSM will become reliant upon the Compact Trust Fund for budgetary support in lieu of direct grants.

181. The table below provides the allocation to infrastructure as calculated each year by OIA and transmitted to FSM prior to the annual budget consultations. The total of $264.2 million represents what FSM is entitled to under the Amended Compact based on the 30 percent allocation (net of the 5 percent IMF). The table also includes JEMCO infrastructure resolution allocations, and USG grant approvals.

Table 5.10 Infrastructure Project Allocations (US$ millions))

Fiscal Year	**Compact Projects**	**JEMCO Allocations**	**USG Grant Approvals**
FY2004	17.1	17.1	0.0
FY2005	17.2	14.5	0.0
FY2006	22.6	23.1	19.8
FY2007	22.9	22.5	5.2
FY2008	23.0	0	3.0
FY2009	23.2	46.0	49.6
FY2010	23.0	23.1	17.4
FY2011	23.0	23.8	24.8
FY2012	23.0	23.7	13.6
FY2013	23.0	0	2.4
FY2014	23.1	0	13.5
FY2015	22.8	0	3.8
Total	**264.2**	**193.8**	**153.1**

182. The unspent/available grant funds for FY2004 – FY2015.

Table 5.12 Available Infrastructure Project Grants by Government (US$ millions)

	Chuuk	Kosrae	Pohnpei	Yap	National
FY2004 - FY2015	40,183,976	11,489,363	35,619,916	10,201,008	11,145,547

Table 5.13 Available IMF by Government (FY2004–FY2015)

	Chuuk	Kosrae	Pohnpei	Yap	National
IMF (5%)	5,694,667	1,604,351	3,380,828	2,115,569	1,063,000

A. Chuuk State

183. The tables below lists the completed Amended Compact infrastructure projects (net of de-obligations) for Chuuk State to the end of FY2014. The fiscal year refers to the year the grants were awarded and not the date that projects were completed. In addition, Weno Road Projects and Other Current Chuuk Projects have also been included.

Table 5.16 Completed Chuuk State Infrastructure Projects)

Fiscal Year	Description	Value
FY2006	Weno Waste Water	864,455
FY2006	Chuuk Hospital Emergency Water	135,000
FY2006	Weno Emergency Power	5,614,763
FY2007	Project Planning & design	58,530
FY2008	Chuuk Schools Renovation	750,000
FY2011	Chuuk Utility (CRISP Capital Recovery)	1,633,800
FY2013	Wastewater Treatment Plant land payment	145,000
Sub- Total		**9,201,548**
	AIP Matching Funds	1,605,154
	ADB Matching Funds	7,690,000
Total		**18,496,702**

Table 5.18 Weno Road Projects (US$ millions)

Fiscal Year	Project	Project Value	% complete	Completion date
FY2006	Weno Road Phase 1	2,273,757	100%	2009
FY2009	Weno Road Civil Works Phase 1	27,175,000	98%	2015
FY2011	Weno Road Construction management	1,514,385	100%	2013
FY2012	Weno Road Phase 1 Change Orders	3,282,000	100%	2013
FY2013	Weno Road Construction Management 3	1,353,000	80%	2016
FY2014	Weno Road Phase 1 Completion	5,200,000	25%	2016
	Total	**40,798,142**		

Table 5.19 Other Current Chuuk Projects (US$ millions)

Fiscal Year	Project	Project Value	% complete	Completion date
FY2010	Architecture, Engineering and Design	1,960,000	79%	FY2015
FY2014	Wastewater Treatment Plant Phase 1	955,000		FY2015
FY2014	Wastewater treatment plant Phase 2	3,700,000		FY2015
FY2014	O & M, Prepayment meters	1,487,917		FY2015
FY2015	Chuuk State Hospital Campus	197,700		FY2015
FY2015	CPUC Generator	470,000		FY2015
	Total	**8,770,617**		

B. Kosrae State

184. The table below lists the completed Amended Compact infrastructure projects (net of de-obligations) for Kosrae State to the end of June FY2015. The fiscal year refers to the year the grants were awarded and not the date that projects were completed.

Table 5.22 Completed Kosrae State Infrastructure Projects (US$ millions)

Fiscal Year	Description	Value
FY2006	Lelu Elementary School	1,426,478
FY2006	Malem/Utwe Power Upgrade	147,250
FY2006	Utwe Elementary School	797,830
FY2007	Project Planning & design	743,813
FY2008	Kosrae Schools Renovation	750,000
FY2010	Architecture, Engineering and Design	1,644,000
FY2011	Kosrae Public Safety & Jailhouse	2,225,000
FY2011	Tafunsak Elementary School	2,210,000
FY2011	Lelu and Utwe Elementary School	5,124,110
Subtotal Projects		**15,068,481**
	AIP Airport matching funds	2,082,648
Total		**17,151,129**

C. Pohnpei State

185. The table below shows completed projects in Pohnpei State. The Nanpil Hydro project and the Water Well Drilling were sub-allotted to Pohnpei Utilities Corporation (PUC) and Army Corp of Engineers, respectively.

Table 5.24 Completed Pohnpei State Infrastructure Projects (US$ millions)

Fiscal Year	Description	Value
FY2006	Nanpil Hydroelectric	556,558
FY2006	Pohnpei Water Well Drilling	1,074,484
FY2007	Project Planning & Design	754,250
FY2008	Pohnpei Schools Renovation	750,000
FY2009	Pohnpei Runway	788,674
FY2009	Kolonia/Madelonihmw High Schools	3,000,000
FY2009	Pohnpei Schools contingency	240,000
FY2009	Nanpei Memorial School	1,765,000
FY2010	Architecture, Engineering and Design	2,688,000
FY2010	Pohnpei Schools Phase 2	5,307,827
FY2010	Pohnpei Schools Phase 2 Contingency	292,173
FY2010	Hospital Generator	50,000
FY2011	PNI Prior Year Funding for Pohnpei State	305,000
FY2012	Pohnpei Hospital Renovation	1,900,000
FY2012	PNI Schools Phase 2 Change Orders	204,460
FY2012	Sekere Water Line Phase 1, Segment 1	1,260,000
FY2013	Pohnpei Hospital Labour	90,000
FY2013	Education Facilities Master Plan	52,500
FY2014	Pohnpei Hospital Emergency Generator	126,000
Subtotal Projects		**21,204,926**
	AIP Airport matching funds	707,500
	ADB Omnibus matching funds	3,540,000
Total		**25,452,426**

D. Yap State

186. Yap State has always been well organised with regards to infrastructure priorities and spending. In recognition of the Amended Compact of priority 1 projects including education and health facilities and water and sanitation the State focused on these projects for the first 10 years of the Amended Compact. Yap now wishes to focus on economic infrastructure projects.

187. The following table lists the Yap State completed Projects.

Table 5.26 Completed Yap State Infrastructure Projects (US$ millions)

Fiscal Year	Description	Value
FY2006	Yap ECE	278,523
FY2006	Yap Hospital Renovation	916,310
FY2008	Yap Schools Renovations	750,000
FY2009	Yap COM Campus Projects	2,100,000
FY2010	Architecture, Engineering and Design	756,000
FY2010	Yap ECE	2,508,350
FY2011	Yap Hospital	7,232,400
FY2011	Yap Outer Island solar	843,750
FY2011	Yap Prior Year Funding	595,563
FY2011	Tomilang Elementary School	2,067,240
FY2012	High School/Voc Ed Building	5,238,000
FY2012	Outer Island High School	229,223
FY2012	Transportation Office Renovation	13,800
FY2012	Water Tank Repair Assessment	100,000
FY2012	Water Treatment Plant Repair	150,000
FY2013	Solid Waste	165,000
FY2013	Education Facility Masterplan	52,500
FY2014	COM-FSM Yap Campus Furniture	100,000
FY2014	Prepayment meters	586,639
FY2014	Yap Hospital Supplement	300,000
Subtotal Projects		**24,983,298**
	AIP Airport matching funds	814,737
	ADB Omnibus matching funds	2,220,000
Total		**28,018,035**

E. National Government

The National Government has two main areas of focus being recognized as national infrastructure, telecommunications and the College of Micronesia National Campus. It also has responsibility for the government administration buildings in Palikir.

Table 5.28 Completed National Government Infrastructure Projects (US$ millions)

Fiscal Year	**Description**	**Value**
FY2006	PMU Operations	2,427,698
FY2006	AIP matching	65,000
FY2007	Project Planning & Design	892,622
FY2009	FSM Airports Master Plan	210,526
FY2010	Architecture, Engineering & Design	2,202,000
FY2011	PMU Operations	694,000
FY2011	Telecom ASDL	360,000
FY2012	PMU Operations	834,212
FY2013	COM-FSM Space Utilisation Study	390,000
FY2013	PMU Operations	1,153,025
FY2014	PMU Operations	315,000
Total		**7,342,083**

VI. THE COMPACT TRUST FUND

188. Table 6.1 shows the aggregate structure of the annual Amended Compact grants and the contribution to the CTF. In accordance with the schedule in Table 6.1 the U.S. will contribute to the FSM $92 million, partially adjusted for inflation. The annual sector grants start at a level of $76 million in FY2004 but are to be annually decremented by $0.8 million beginning with FY2007. The difference between the total contribution and the annual sector grant levels will be deposited in a trust fund.

189. The Amended Compact established a Trust Fund for the People of the FSM (CTF). The annual decrement in U.S. sector grants amounts is the annual increment to U.S. contributions to the trust fund. Table 6.1

190. Due to the structure of the Trust Fund Agreement, there is no guarantee that the CTF would provide a specified amount annually. Article 16(7) of the Trust Fund subsidiary agreement provides a framework for annual distributions from the Trust Fund, identifying the maximum allowable annual distribution:

> *7. The Joint Trust Fund Committee may disburse to the Government of the Federated States of Micronesia, from the B Account (supplemented from the C Account if the B Account is insufficient):*
>
> *(a) in Fiscal Year 2024, an amount equal to the Annual Grant Assistance in Fiscal Year 2023, plus Full Inflation; and*
>
> *(b) beginning in Fiscal Year 2025, and thereafter, an amount of funds no more than the*

Table 6.1 U.S. annual Compact grants and contributions to the Trust Fund (US$ millions)

	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

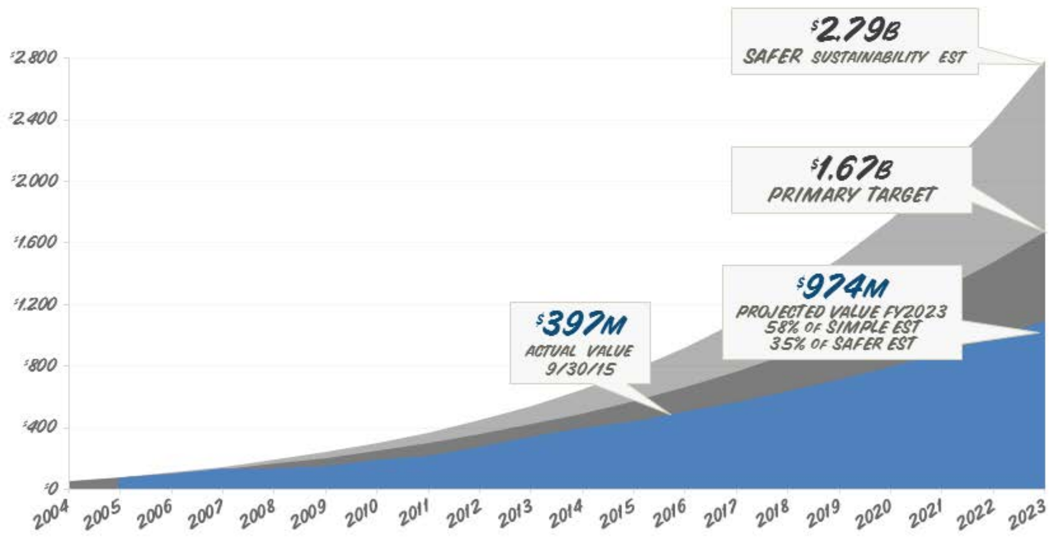

Figure 6.1 Primary target, projected value and SAFER estimate through FY2023

amount equal to the Annual Grant Assistance in Fiscal Year 2023 plus Cumulative Full Inflation thereon, plus any additional amounts for Special Needs approved under paragraph 5(c) above.

A. Performance of the Compact Trust Fund (FY2004-FY2015)

191. The Fund's restricted fiduciary net position value increased 4.3% from $380,901,011 for FY14 to $397,313,588 for FY15. It should be noted that the FSM has not funded the "D" account within the CTF mechanism; rather the FSM has created its own FSM Trust Fund. The value of that account at the end of FY2015 is estimated in the range of $40 million or roughly 10 percent relative to the size of the CTF at that date. To the extent the FSM utilizes its current observed structural surplus to continual substantial annual contributions to the FSM Trust, it could develop an important supplemental funding source to mitigate periodic or sustained fiscal shocks.

192. Figure 6.1 indicates that if growth from the end of FY2015 is 7.0 percent in nominal terms through FY2023, the median value of the CTF is projected to reach $974 million. This is approximately more than half of the value the fund would need to be in order to provide for the maximum allowable distribution contemplated under the Trust Fund Agreement.

193. It must be emphasized that even achieving a CTF value that matches or narrowly exceeds the value needed to initially support the maximum allowable distribution does not, by any means, eliminate the risks going forward of subsequent severe and repeated fiscal shocks under the framework currently contemplated under the TFA.

B. Trust Fund Analyses

194. Figure 6.3 shows the probability distribution of outcomes starting with the known value of the CTF at the end of FY2015. There is just a 6 percent probability of achieving the maximum allowable distribution.

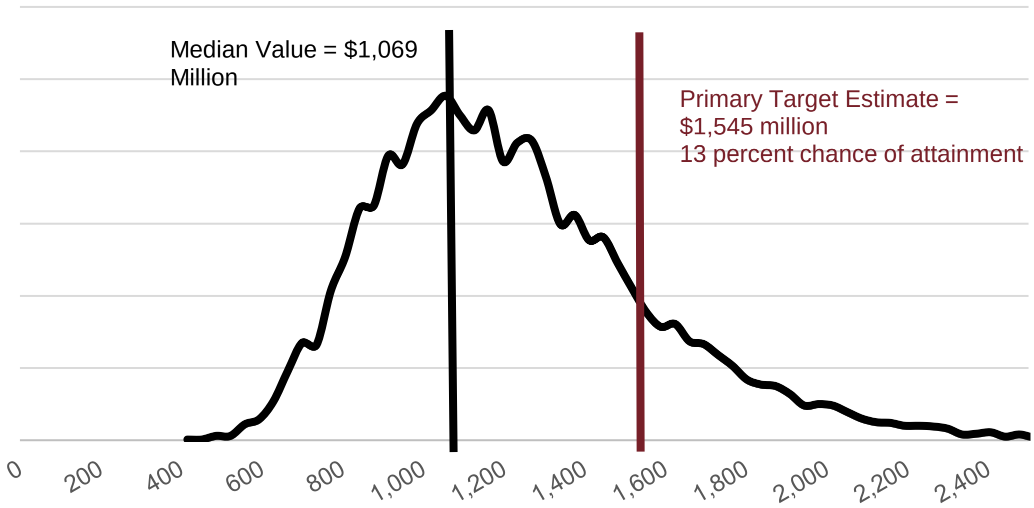

Figure 6.2 Projected FSM Trust Fund value through FY2023

195. Several recent studies of the Amended Compact Trust Funds in the FSM and RMI[15] both deploy Monte Carlo simulation analysis to investigate the likely performance of the two Trust Funds. According to these studies, there is a significant risk of a zero distribution year in which no money is available for the people of the FSM because of the distribution framework.[16]

15 See U.S. Government Accounting Office, *Trust Funds for the Micronesian and the Marshall Islands May Not Provide Sustainable Income*, GAO-07-513, June 2007, Washington D.C.; and Asian Development Bank, *Trust Funds and Fiscal Risks in the Federated States of Micronesia and the Marshall Islands: Analysis of Trust Fund Rules and Sustainability in an Evolving Aid Relationship*, 2015, Manila.

16 See U.S. Government Accounting Office, Trust Funds for the Micronesian and the Marshall Islands May Not Provide Sustainable Income, GAO-07-513, June 2007, Washington D.C.; and Asian Development Bank, Trust Funds and Fiscal Risks in the Federated States of Micronesia and the Marshall Islands: Analysis of Trust Fund Rules and Sustainability in an Evolving Aid Relationship, 2015, Manila.

VII. RECOMMENDATIONS

196. Four (4) recommendations are made in the following categories: Making Amended Compact Grant Assistance More Effective; Compact Trust Fund; Federal Programs; and Technical Changes to the Fiscal Procedures Agreement.

1. MAKING AMENDED COMPACT GRANT ASSISTANCE MORE EFFECTIVE

197. As noted by the U.S. Government Accountability Office (GAO), the FSM has not developed adequate data and reporting systems to be able to demonstrate progress in the health and education sectors, where the bulk of Amended Compact funding has been expended. It is clear that during the Amended Compact, there has been limited progress on monitoring of either results (outcomes) or deliverables (outputs). There is a need to ensure that health and education statistics and performance monitoring can be reliably used to inform the JEMCO decision-making regarding the effective use of Amended Compact sector-grant funding and monitoring by U.S. grant managers. JEMCO could be made a more effective body by enacting the recommendation described below.

- Recommendation No. 1—At this time, the United States should continue funding support for maintenance of economic performance reporting for the FSM, and encourage the FSM to fund development and maintenance of reliable and verifiable health and education sector data and performance reporting systems. JEMCO should consider allocating Compact sector funds in the health sector for these same purposes

2. THE TRUST FUND

198. ***The Compact Trust Fund Level:*** Both the U.S. and FSM governments have expressed concern that the Trust Fund as currently structured as well as the size of the corpus may not be sufficient to meet the needs of both Parties. The Trust Fund would benefit from actions by the original Parties to supplement the CTF from all sources, including from Subsequent Contributors. Some technical amendments may be desirable to better meet the objectives of the Original Parties after FY2023, and both Parties should consult on their respective objectives for the Trust Fund and the most appropriate path to achieving them.

- Recommendation No. 2—Secure additional funding from the FSM and from other donors and sources; assess the possibility of contributing unallocated (carryover) sector grant funds into the CTF; and

- Recommendation No. 3: Start discussions as soon as possible with GFSM for ways in which the Trust Fund can better meet the needs and objectives, including reducing the likelihood of a zero distribution year, of the Parties including potential Amendments to the Trust Fund Agreement.

3. FEDERAL PROGRAMS AND SERVICES

199. Uncertainty as to the range and level of programs and services that U.S. federal services and agencies will continue to make available to the FSM after FY2023 has been raised by the GoFSM as a concern. As the end of the period of direct U.S. financial assistance under the

Amended Compact approaches, uncertainty could impact decisions by potential investors and, critically for U.S. states, choices that individuals and families make about possible emigration.

- Recommendation No. 4—After the United States clarifies the status of U.S. federal programs, assistance, and services currently provided in the FSM, the United States should work with the FSM to appropriately assess which programs and services are appropriate to be continued after FY2023.

4. The FPA: Dates, Definitions, and Reporting Requirements

200. The Amended Compact sector grants and SEG are subject to the reporting and accountability requirements of the FPA. After 10 years of implementation, it is clear that a few changes would be beneficial to either correct errors or better reflect the conditions in which the FSM must fulfill its commitments.

- Recommendation No. 5—Amend the FPA so that:
    - The due date for the Section 214 Annual Economic Report, as specified in Article V(1)(d), should be changed from February of each year to the end of July each year. The current timeline is difficult to achieve, given the desire to use audited figures, other reporting requirements, and limited capacity.
    - For consistency with the Single Audit Act, the due date for the annual single audit as specified in Article VIII should be changed from the beginning of the third quarter to the end of the third quarter (June 30) of the fiscal year following the fiscal year under review.
    - FPA Article VI, section 2, Program Monitoring, Performance Reports, and Records Retention, should be changed to specify that the fourth-quarter report format covers the full fiscal year, and the due date should be changed from 30 days to 60 days after the end of the fiscal year.