

Report to the Congress

on the

Compacts of Free Association

with

**the Federated States of Micronesia (FSM)
and the Republic of the Marshall Islands (RMI)**

For Fiscal Year 2006

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Introduction

The United States entered into a Compact of Free Association (Compact) with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) in 1986. The purpose of the Compact was to establish close and mutually beneficial relationships between the United States and the FSM, and between the United States and the RMI as they emerged from the Trust Territory of the Pacific Islands and became sovereign states.

The Compact was made a part of and approved in Public Law 99-239. The Compact set out mutual obligations with regard to governmental, economic, security and defense relationships. One part of the Compact dealt with economic support provided the FSM and the RMI by the United States. Between fiscal years 1986 and 2003, the last year of funding under the Compact's original terms, the FSM and the RMI received approximately \$1.5 billion and \$1 billion, respectively, from the United States. The funds were used for general government operations, including health and education, economic development, capital improvements, and special purposes.

Some of the provisions of the original, 1986 Compact, including the economic assistance provisions, were to expire in 15 years. The Compact provided that, starting in 1999, the parties were to enter into negotiations regarding these expiring provisions. The negotiations culminated in separate amended Compacts with the FSM and the RMI, which were made a part of and approved in Public Law 108-188, the Compact of Free Association Amendments Act of 2003. The amended Compacts provide United States support for a 20-year period that began in fiscal year 2004. The FSM will receive approximately \$2.1 billion and the RMI \$1.5 billion during that period, including large annual and increasing contributions to trust funds designed to provide an annual source of revenue when the annual United States assistance terminates at the end of fiscal year 2023. Through fiscal year 2023, United States assistance will be for grants for education, health care, private sector development, the environment, public sector capacity building, and public infrastructure, with priorities in the education and health care sectors.

The amended Compacts created new accountability requirements for the use and reporting of United States assistance. One of the requirements of Public Law 108-188 is this report.

(A) General Social, Political, and Economic Conditions:

Section 104(h) of Public Law 108-188 requires the President of the United States to report on general social, political, and economic conditions in the FSM and the RMI, including, among other things, estimates of economic growth, per capita income, and migration rates. This reporting requirement has been delegated to the Secretary of the Interior.

Federated States of Micronesia (FSM)

Background

The strategic and economic relationship between the FSM and the United States that goes back to the end of World War II has had three distinct phases: (1) the period from the end of World War II to the end of the Trust Territory of the Pacific Islands in the 1970s, (2) the first financial package of the Compact of Free Association, 1986-2003, and (3) the terminal phase of the financial package, the amended Compact, 2004-2023.

The principal outcome in the first phase was putting in place modern institutions of self-government, based mainly on American style of democratic principles and practices. It was during this period that the FSM, an archipelago in the Central Pacific that stretches 1,700 miles from east to west and inhabited by a population of under 110,000, evolved into a self-governing entity and joined the community of nations as a sovereign state. A steady income source in the form of U.S. grant assistance during the second phase helped the FSM expand its infrastructure and explore various economic growth and development programs that would expand domestic production and distribution. The expectation was that higher levels of output from local sources and resources would increase economic and financial self-reliance. An important measure of self-reliance was envisaged to be a steady and sustained increase in the domestic tax base as the economy's productive capacity increased, mainly through the private sector.

The third phase, the amended Compact, took effect in fiscal year 2004. The principal task during this phase is to build upon the work of the second phase and help the FSM lay the foundation for a more self-reliant economy that would be based more on the private sector than at any time during this relationship. It was with this objective in mind that the FSM and U.S. negotiators agreed to an important new element in the third phase. With respect to Compact grants under the amended Compact, a Joint Economic Management Committee (JEMCO) was established to strengthen management and accountability and to promote effective use of the Compact grants. JEMCO, in which the United States retains permanent majority (three of five votes), enables United States Government to monitor progress more closely and focus grant assistance on areas that would help the FSM get on the track to a greater degree of self-reliance. The areas of particular emphasis are public health and public education, which will receive the largest share of the total grant assistance every year through the end of fiscal year 2023. Other areas to receive U.S. grant assistance are private sector development, the environment, public sector capacity building, and public infrastructure.

Another important part of the amended Compact is a trust fund for the people of the FSM that, after its 20-year accumulation period, would generate a source of income to be used for the same purposes as the 2004-2023 grant assistance once annual U.S. assistance grants end.

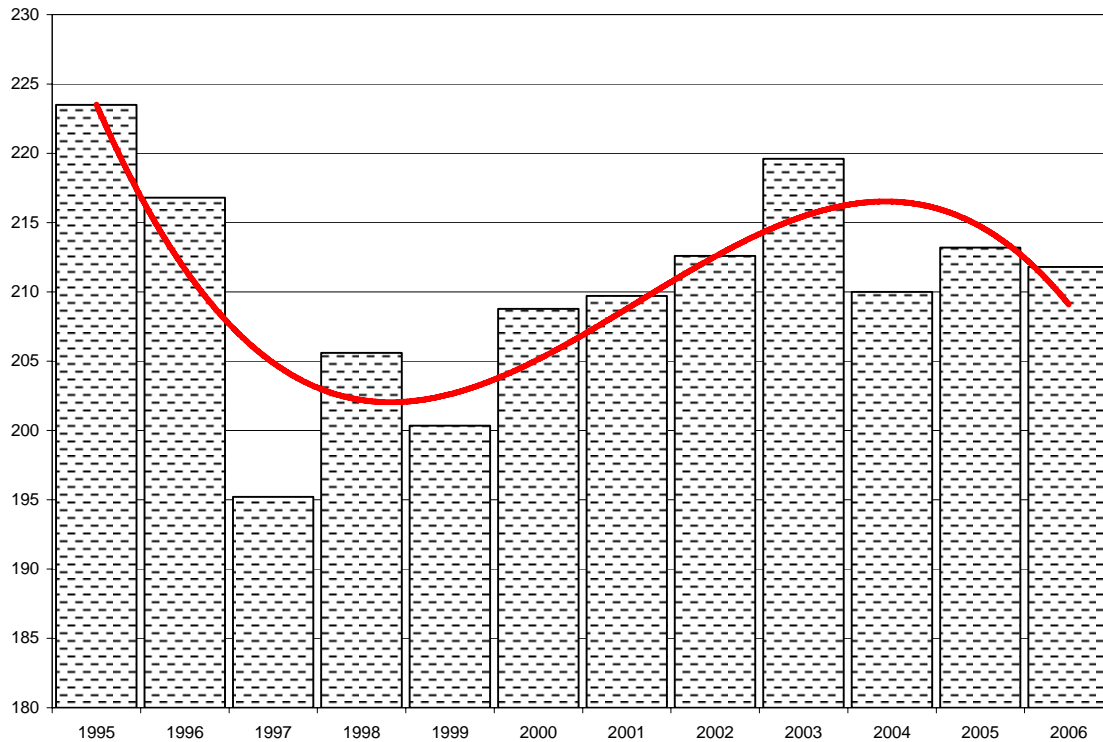
Apart from reviewing and approving grant allocations each fiscal year, JEMCO also has responsibility for identifying ways to increase the effectiveness of U.S. assistance, and to

attach special conditions to grants to improve program performance and fiscal accountability and ensure progress toward macroeconomic goals. It is in this context that JEMCO can encourage institutional reforms crucial to prosperity in the market place of the global economy. These new features, focusing grant assistance on targeted segments, identifying areas for reform and provision for an income stream beyond the terminal phase, make the amended Compact a pivotal chapter in the evolution of the FSM as an economy and a society. The reliable operational grant and trust fund deposits the United States will provide over the next 17 years offer the people of the FSM a horizon of sufficient length in which to lay the foundation of the post-Compact FSM economy. It is in this context that the economy of the FSM needs to be reviewed and both its challenges and promises outlined clearly.

Meanwhile, the change in allocation and spending control has slowed implementation of the amended Compact. It has taken the four FSM state and national governments longer to adjust to JEMCO's role in reviewing and approving grant allocations. Also, unlike the beginning of the second phase where large startup funds boosted total economic output rather quickly, there were no large upfront grants at the start of the third phase to cause a large increase in the flow of funds in the economy and, eventually, in total output and the average standard of living.

According to the FSM's report to the President of the United States for fiscal year 2005, real gross domestic product (GDP) was projected to be down in fiscal year 2006 from fiscal year 2005. However, this is in line with what can reasonably be characterized to have been a stagnant FSM economy through most of the new decade. The main reason for stagnation has been lackluster performance in the FSM's private sector economy. In fact, the private sector and households as a share of the FSM's GDP in fiscal year 2006 was down for the second consecutive year.

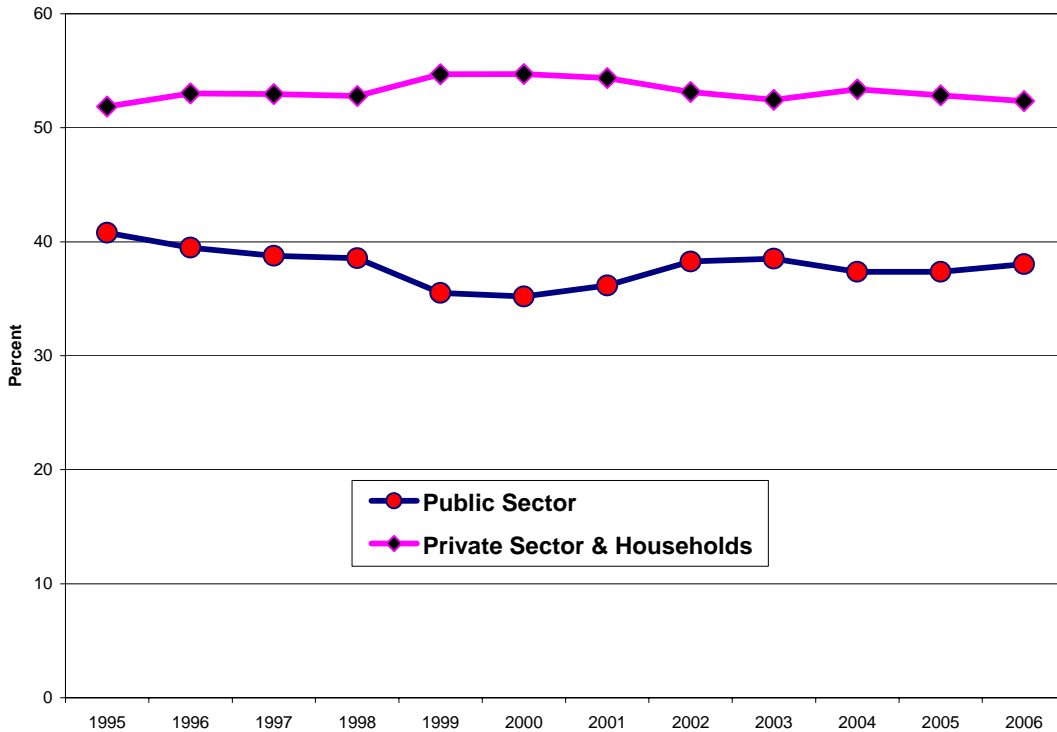
FSM Real GDP (Millios of 1998 Dollars)



Information in the report to the President also shows that the FSM's private sector output as a share of GDP has changed little in recent years. In fiscal year 2006, the private sector's output was 27.6 percent of GDP, down slightly from the year before but in line with the long-term trend. In 1995-2006, private sector output averaged 28.6 percent, ranging from a high of 29.8 percent in 2000 to a low of 26.6 percent in 1997.

Now that the amended Compact is in the fourth year of implementation and there is no prospect for bump-up funds, the near term outlook for the FSM economy does not appear very bright. Taking this argument to its logical end and assuming no large sums of external funds from other sources suggests that the only practical option to increase the FSM's total output and, therefore, the average standard of living is to increase its private sector's share of national income. Given the economic and political history of the FSM, at least since the beginning of the U.S.-FSM relationship, this will not be an easy task. Meanwhile, the Office of Insular Affairs, the U.S. Government agency responsible for monitoring Compact progress, has made it clear, specifically at the 2006 JEMCO meetings, that there is no alternative to private-sector growth if the FSM economy is to deliver the income a growing population will need. Migration to the United States and its territories, an important provision of the Compact, undoubtedly relieves some of the population pressure, but migration alone is not a sufficient condition for improved standards of living, especially for those who have to stay behind in the islands.

Shares of FSM GDP by Major Sectors



Public Law 108-188 section 140(h)(1), requires this annual report on the FSM by the United States Government. It provides information on, among other things, the use and effectiveness of United States financial, program, and technical assistance funds, the status of the economy and economic policy reforms, and the status of the efforts to increase investment in the FSM's overall productive capacity.

This report for fiscal year 2006, the third since the amended Compact has been in effect, is submitted in fulfillment of that requirement. The report is based on three principal sources of information. The quantitative economic analysis is based mainly on the data contained in the FSM's Report to the President of the United States, required by section 214 of the amended Compact. This Report discusses the use of United States grant assistance, the FSM economy and progress in meeting mutually agreed program and economic goals.¹ The quantitative analysis of United States sector grants and overall U.S. assistance is based on information gathered from the various FSM governments. The third source of information and insight is a team of Federal employees with the specific task of monitoring progress of the amended Compact. The team's extensive experiences and expertise cover practically all of the FSM islands. Most members of this team are experts in their respective fields and they collectively constitute the most

¹ The FSM's second report, for fiscal year 2005, to the President of the United States was received by the Department of the Interior in September 2006. The FSM has not yet submitted its report for fiscal year 2006.

authoritative body of knowledge on the Compact, implementation challenges and promises and what lies ahead for the FSM and the FSM-U.S. relationship.

Economic and Financial Review of the FSM

Economic statistics for the FSM over the last decade present a picture of an economy besieged by large fluctuations, followed by stagnation and decline. The economy recovered from a steep decline in the late 1990s to a somewhat steady and predictable course during 2000-2003. Since 2003, it has stagnated. In 1995-2006, FSM's real GDP increased a scant 0.1 percent a year. The State of Yap, the second smallest state in terms of population but economically the strongest of the four states since the beginning of the first Compact, was the only economy of the four states that grew. However, the growth rate was less than one percent a year in 1995-2006. During the same period, Chuuk's economy grew 0.2 percent a year, followed by 0.1 percent decline annually for both Pohnpei and Kosrae.

As a share of the FSM's GDP, the public sector declined more than the private sector, owing to cuts in U.S. assistance and reforms in the public sector intended to cut cost and streamline government operations. In 1995-2006, government as a share of GDP declined 0.9 percent a year while private sector's share dropped 0.3 percent annually. The states followed the FSM's GDP change during the period, with the private sector's share growing in Yap (1.2 percent a year) and Chuuk (0.7 percent a year) and declining in Pohnpei (1.2 percent) and Kosrae (1.0 percent). Government as a share of GDP during the 1995-2006 period remained unchanged in Kosrae, but declined in every other state.

A part of the explanation for the private and public sectors in the FSM and its four states moving almost in tandem is the peculiar nature of the private sector. As noted in the previous report and elsewhere, the private sector economy in the FSM and its four states is dominated by services that support government activities and households which also depend, in large part, on government payroll and contracts. The traditional production economy in the FSM, including subsistence output, is a small part of the whole and, as it is, does not have the capacity to generate more output and, therefore, more taxes. This unusual structure of the economy, where the private sector is more of a support system for the public sector rather than the engine of growth it ought to be, is at the heart of lackluster economic performance over the last several decades.

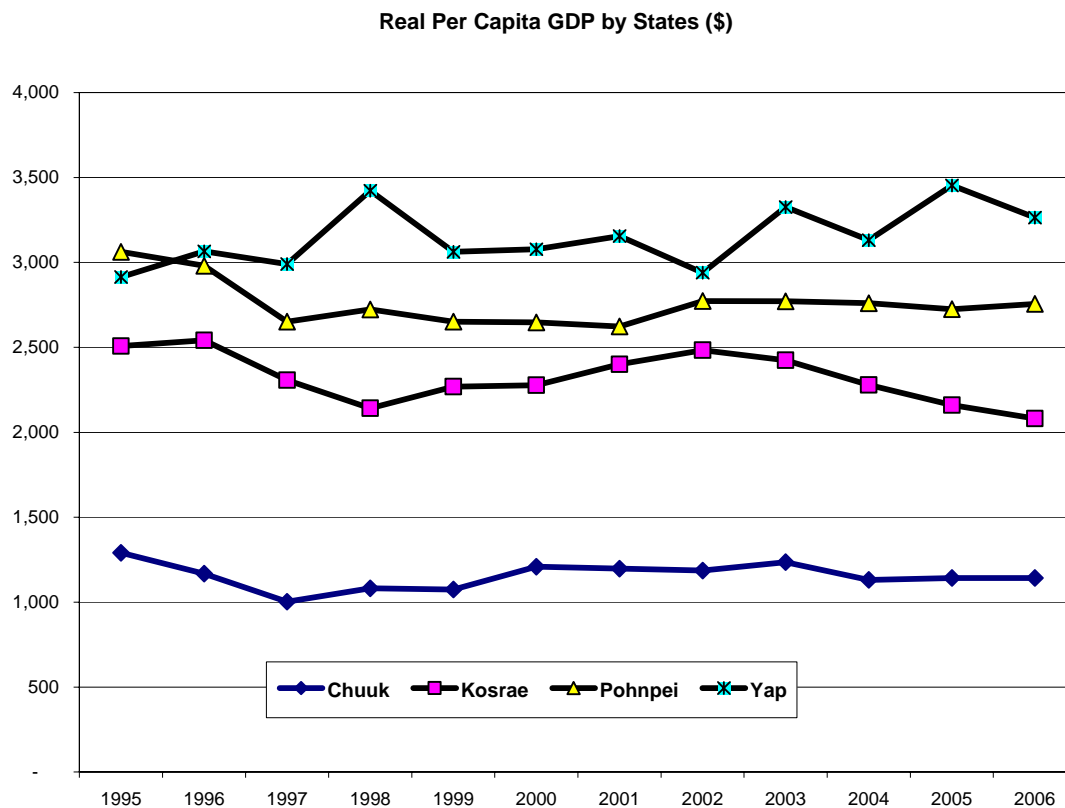
A major challenge policy-makers in the FSM face is to change this relationship between the private and public sectors. This is to take place mainly through improvements in public health, public education, public infrastructure, public sector capacity building, support for the private sector and the environment and institutional reforms. Success in changing the nature of the FSM's private sector would require commitment of all decision-makers to agree what the challenge is and join forces to develop a credible and practical strategy for private sector growth.

Average Real GDP Growth Rates per Year by States and Economic Sector, 1995-2006

| | GDP | Government | Private Sector |
|------------|------|------------|----------------|
| Chuuk | 0.2 | -1.6 | 0.7 |
| Kosrae | -0.1 | 0.0 | -1.2 |
| Pohnpei 1/ | -0.1 | -0.7 | -1.0 |
| Yap | 0.9 | -0.5 | 1.2 |
| FSM | 0.1 | -0.9 | -0.3 |

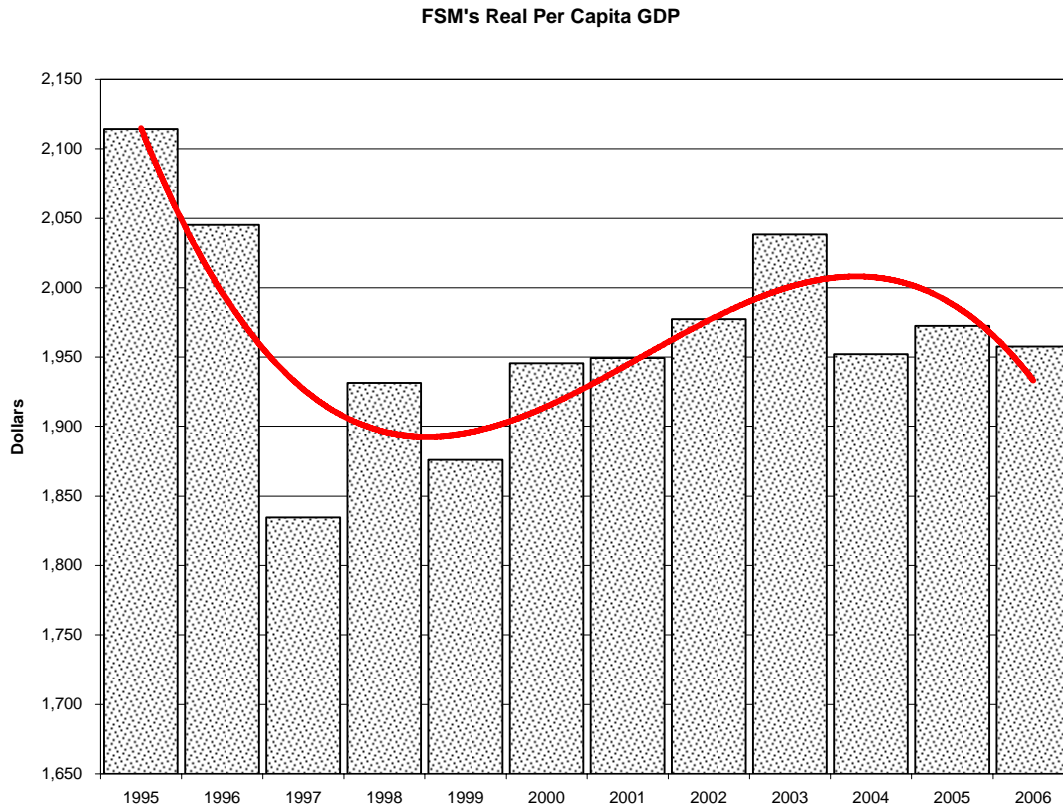
1/ includes the national government

Source: *Federated States of Micronesia FY 2005 Economic Review*, August 2006, p. 2.
(This is the FSM's Section 214 Report submitted to the President of the United States.)



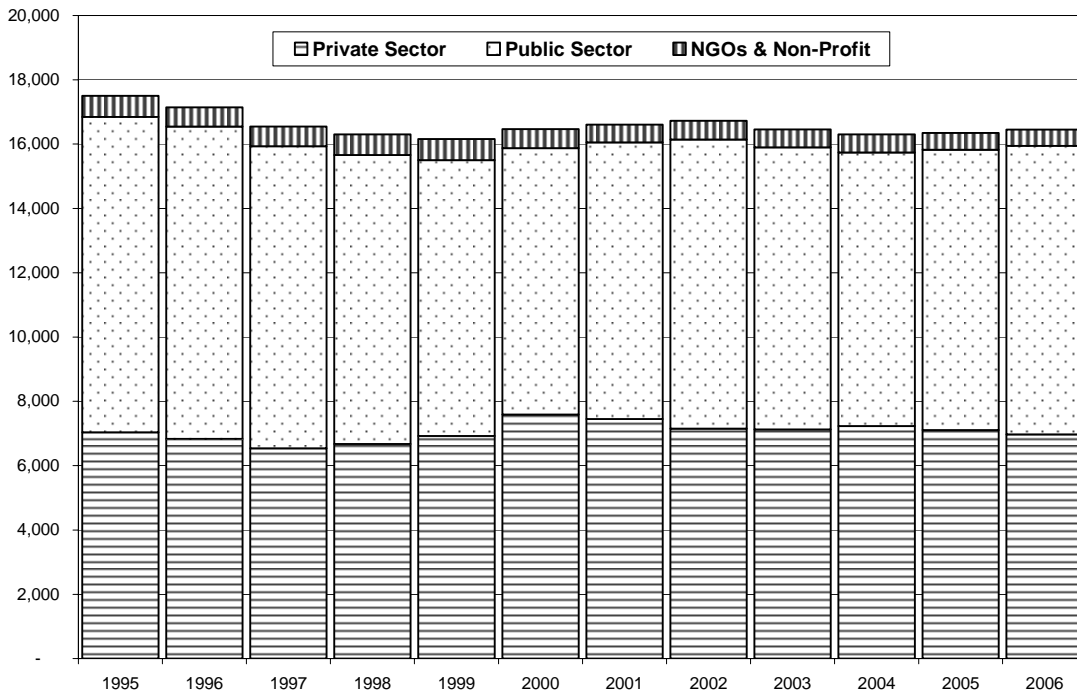
The necessity of improving private-sector growth prospects in the FSM can also be discerned from income and standards of living data contained in the FSM's Section 214 Report. Yap was the only state which had a higher real per capita GDP in 2006 than in

1995. Each of the other three states had a lower per capita GDP in 2006 than a little over a decade earlier. By necessity of their respective weights in the total national income, the states with declining per capita income pushed the FSM as a whole in the direction of loss of purchasing power for the average citizen. Among the state losing ground in terms of real per capita GDP, Kosrae exhibited the greatest potential for future problems, in part, because it relies more heavily on government than any other state. Its real per capita GDP dropped every year in 2003-2006.



The FSM's payroll employment data corroborate the evidence of a static economy provided by output and income figures. Total employment in the FSM in 1995-2006 remained remarkably stable, ranging from a high of 17,502 in 1995, the peak of the business cycle during the second phase, and 16,162 in 1999. In the years after 1999, employment recovered somewhat, but did not match the previous peak level. It averaged 16,585 during the 1995-2006 period. Another remarkable aspect of the employment data is the mix of private and public employment. Employment data in the FSM's Section 214 Report are presented by categories within the private and public sectors. While detailed breakdown of employment types is useful for insight into the FSM's labor market, the two broader categories, private sector and public sector, have changed little over the years.

FSM's Payroll Employment



Public-sector employment consists of public enterprises, national government, state government, municipalities and government agencies. Private-sector employment is made of private sector businesses, financial institutions and households. The third category is made of non-governmental organizations, non-profit outfits and embassies. The changes within these three broader categories in the 1995-2006 period reflect the static nature of the underlying production and distribution systems.

As pointed out in last year's report, a critical and potentially destabilizing factor in the FSM is the low ratio of formal employment to population. In 2006, 15.2 percent of the population of 108,549 was formally employed, with formal employment being defined as work for pay. In 1995, a peak in the business cycle, this ratio was 16.5 percent, the highest. During the 1995-2006 period, employment as a percent of total population averaged 15.5 percent.

By contrast, employment as a share of total population in the United States, for instance, was 47.3 percent in 2003 and averaged 47.2 percent over the 1990-2003 period. This is not to compare the population composition of the FSM to the United States. However, the low ratio of employment to population does suggest that increases in the standard of living will be harder to achieve because of the small percentage of the population participating in the formal economy that supports the rest of the population. Given these facts, it is a reasonable argument to make that more Micronesians, not fewer, would resort to emigration. With subsistence economy still being an important part of the

whole, about 15 percent of GDP, it generates both goods for domestic consumption and some work. However, there is no information on the market value of subsistence output or the equivalent of the labor force it employs.

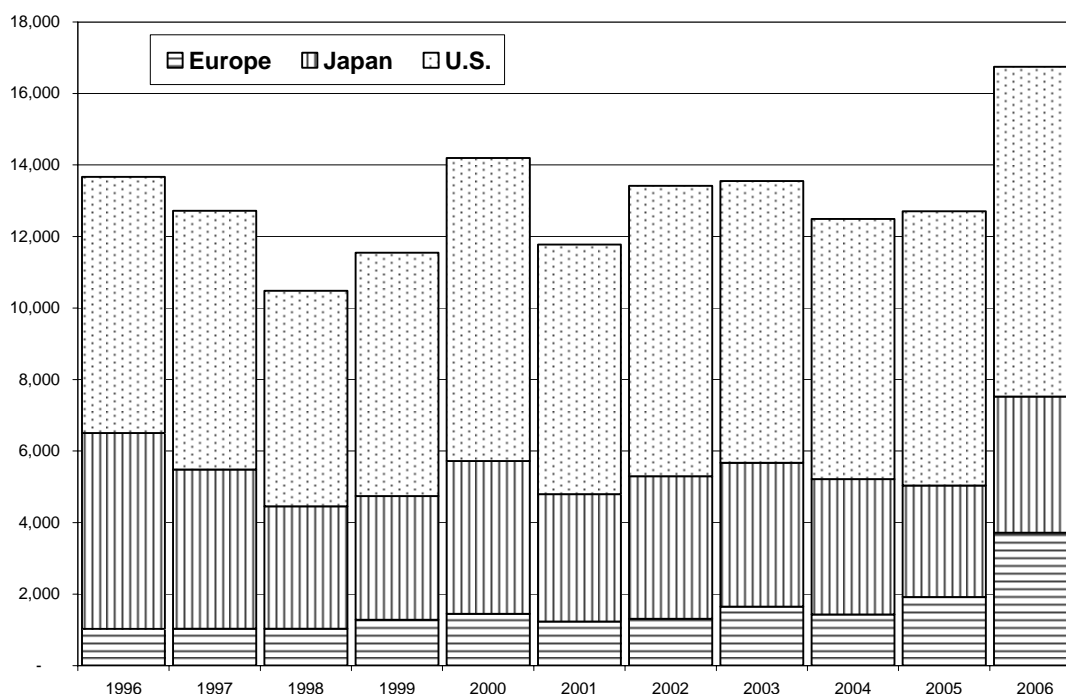
Prospects for Private-Sector and Economic Growth

The FSM faces serious challenges in the years ahead. Its public sector, especially the part that relies on U.S. assistance, must be reduced by a certain amount every year through fiscal year 2023, because of mandated decrements. (The amounts of decrements get deposited into the trust fund.) The FSM private sector has traditionally been smaller and lagging and has so far under the amended Compact shown little prospect for growth. Unless the FSM can significantly increase tax and other revenues through its private sector, U.S. grant assistance reductions necessitate difficult adjustments in state and FSM government budgets every year and, as a result, have the potential for loss in the prevailing standards of living. These circumstances make the call for private-sector growth much more urgent.

Among the challenges FSM must confront are inherent constraints. For example, commercial agriculture holds limited potential because of limited land and lack of major comparative advantages. Among the options to reduce pressures on the limited resources is migration to the United States and its territories. but not everyone in the FSM would be expected to leave. The key question is: for those who stay, what would be the best path to a post-Compact economy that can reasonably offer both work and reward for those who will continue to reside in FSM?

The answer may lie, in part, in putting in place a mix of physical infrastructure and institutional reforms that would make access to the FSM's land, water and human resources less taxing. The role adequate infrastructure plays in expanding production and distribution possibilities cannot be exaggerated, especially in remote and small markets. The argument that adequate infrastructure leads to a greater productive capacity may be presented to global and regional bodies such as the World Bank and individual governments such as Japan that may, in turn, consider the FSM for infrastructure and reform assistance. Adequate infrastructure would particularly aid tourism and fishing. To initiate projects of such a scale to make a difference in the national output would require concrete proposals from the FSM that would demonstrate both the technological and financial feasibilities of greater output.

FSM Visitor Arrivals



For example, to bring large numbers of Japanese tourists to the FSM to explore World War II wreckage sites, dive, and do other things in the unspoiled waters of the Central Pacific, would require ground facilities that can accommodate wide-bodied jets and large numbers of visitors. To extend runways, for example, and build regionally competitive hotels would require large sums of money. To convince regional banks or other bodies that they should invest large sums in small markets such as the FSM or its individual states would require diligent work on what the production and distribution possibilities are, how they are going to be developed, and how they are going to change the social, economic and financial realities so that the average standard of living would rise.

In the FSM, tourism and the fishing industry are about the only realistic options for economic growth in the context of traditional goods-production possibilities. To haul large quantities of fresh fish from the region to Asian markets such as Japan would require runways and commercial aircraft or other means of transport that carry large quantities of perishable products over long distances. Processing some of the fish in the islands so some of the value added stays would require processing facilities. Taking steps to create the next economy of the FSM and, for that matter, of the Republic of the Marshall Islands (RMI) and the Republic of Palau may require the direct involvement of regional and global institutions and regional economic powers such as Japan, Taiwan and Australia. Engaging global and regional resource centers also falls within the scope and spirit of the FSM's own Strategic Development Plan (SDP), which is required by the

amended Compact. Realization of the sustainable growth strategy, as outlined in the SDP, would require, more or less, the same infrastructure.

As the FSM contemplates how to make its case to the outside world for resources to enlarge its production and distribution possibilities, it may also undertake the institutional reforms that would make the FSM a more open, transparent and attractive market, despite the disadvantages of distance and small landmass. Reform efforts would focus on land tenure, the tax system, foreign investment control and improvements of local telecom systems that would make access to global sources of information convenient. With transparency and adherence to global and regional trade and commerce rules, service industries such as shipping registries, offshore financial services outfits, web hosting and others may be feasible. Collectively, these reforms would have the capacity to improve the FSM's business climate which has recently received considerable attention in the context of regional and global development discussions.

Recent studies of regional and global business climates by the World Bank and the Asian Development Bank (ADB), in particular, have highlighted deficiencies in the business climate of small economies, not just in the Pacific but around the world. Because of small landmasses and remoteness, small economies do not get the attention large ones do, especially in the context of foreign trade and capital flows. However, when they do, they often get less than glowing reviews because small economies tend to be slow to follow global and regional changes and trends. Also, cultural perceptions and practices of small and isolated places tend to be out of phase with regional and global changes. As the ADB points out in a recent economic report on the FSM, "In Micronesia, land is wealth, power, spirituality, identity, and the basis for life itself. Land is a valuable cultural asset and a priceless heritage to be passed on to future generations."² It is for this and similar reasons that landownership in the Pacific in general and Micronesia in particular is restricted to indigenous persons. Putting limits on market parameters that are contrary to regional and global standards is popular because land is, essentially, the only reliable source of sustenance in most of the small economies. Alienation of land is generally considered to be an unacceptable price to pay for change.

Meanwhile, to deal with the needs of the land market, land lease laws have been enacted in some of the FSM states, but they are not uniform and lack the flexibility of the region's more open markets such as Guam and Hawaii. A more open and flexible land market, where lease rights are transferable, would be an important step to establishing a dynamic economy with a more favorable business climate.

The business climate studies the ADB has conducted in the Pacific in recent years have particularly been useful in pointing out not only what the business climate issues are, but how to resolve them so small and isolated economies can be, at least on the basis of some criteria, considered to be in the game. Among ADB's recent business climate studies of the Pacific is *Swimming Against the Tide?* The message of the study is quite simple. It says, "The private sector in the Pacific is handicapped by common problems including a

² Asian Development Bank, *Federated States of Micronesia 2005 Economic Report* (Pacific Studies Series), 2006, p. 20.

weak macroeconomic environment, poor governance, often political instability, extensive state involvement combined with weak regulations and, underdeveloped financial markets, and a poor legal and investment policy environment for business.”³

Improving the business climate in small and isolated markets of the Pacific may be like swimming against the tide, but the necessity of market realities of this day and age calls for it. In the context of the FSM’s post-Compact economic future, swimming against the tide amounts to accepting the proposition that the private sector has to expand to its fullest potential so the declining Compact grants do not mean declining living standards or inevitable migration.

Recognition of the business climate challenge in the Pacific is also an important issue with the World Bank, whose nine Pacific members include the FSM, the Republic of the Marshall Islands and the Republic of Palau. In its Pacific Islands Strategy, the World Bank says about the FSM that, “To maximize the potential of agriculture, fishing and tourism, structural reforms are required in land tenure, human capital investment, the public enterprise systems, and the legal and institutional framework to foster private sector activity.”⁴ To be sure, this and other reform messages are not new. They have been reiterated by world and regional institutions over the years. What may be new is the reality that the public sector cannot sustain the FSM’s economy any more, even at stagnant standards of living.

Migration from the Freely Associated States

Migration from the freely associated states (FAS) to the United States and its territories began after the Compact took effect in 1986, but it did not get much attention until recently, when Hawaii, Guam and Commonwealth of the Northern Mariana Islands (CNMI) raised concerns about the cost of public services for migrants from Micronesia. These concerns became the basis of funding to these United States jurisdictions that is a part of Public Law 108-188. Based on 2003 data, there were 20,808 Micronesians in the United States island areas, with the following distribution:

| | |
|----------------|-------|
| Hawaii | 7,297 |
| Guam | 9,931 |
| CNMI | 3,570 |
| American Samoa | 10 |

(Migrants to the mainland United States have not been enumerated, but may be expected to equal or exceed those in the island areas.)

As these numbers show, Micronesian migrants to the United States and its territories, although not a large number or a significant portion of all immigrants, are a large percent of the population of the areas from which they migrate. The total of 20,808 in 2003 was

³ Asian Development Bank, *Swimming Against the Tide? (Pacific Studies Series)*, 2004, p. xi.

⁴ The World Bank, *Pacific Islands Strategy*, 2005, p. 43.

about 11.5 percent of the total population of the FSM, the RMI and Palau combined. Thus far, the bulk of the migrants are coming from the FSM, especially Chuuk; it is expected that future trends in Micronesian migration will likely mirror the past.

Republic of the Marshall Islands (RMI)

Background

The RMI and the FSM share some of the basic provisions of the amended Compact, such as annual grant assistance decrements and the decrement amounts going into their respective trust funds. The annual amounts of grant assistance and trust fund deposits are different, because of differences in the populations and economies of the two countries. The RMI economy is not only smaller than the FSM's but also less complicated. However, the long-term growth and prosperity challenges it faces are similar to those of its neighbor. Unlike the FSM, the RMI has a large and powerful national government, coupled with small and much less powerful municipal (village) government. The RMI has no states and, therefore, no state government the national government has to contend with, but the main point of similarity to the FSM is that its public sector is the dominant source of income and sustenance. In the context of income, the RMI's other main difference from the FSM and one of its key strengths is the presence of a U.S. military base in the RMI. The Ronald Reagan Ballistic Missile Defense Test Site (Reagan Test Site, RTS) is an important income source for the RMI. It employs a large number of RMI residents and pays annual impact payments to landowners on Kwajalein Atoll, where RTS is located. The 1,161 employees of RTS in 2006 were 12.1 percent of total employment.

As measured by GDP, the RMI economy is about 60 percent of the FSM's and its population is about half. In 2006, RMI's GDP was \$137.8 million, as compared to \$244.7 million for the FSM. Unlike the FSM's, the RMI's GDP was up 4.9 percent from the year before, following six consecutive years of growth. Although some of the growth rates in those seven years ending in 2006 were low, near or just slightly more than the rate of inflation, the RMI's economy has performed more favorably than that of its neighbor. The principal cause of growth has been the bulging public sector and among the reasons for rising public spending has been grants from other donors, such as Taiwan. The competition for diplomatic recognition between Taiwan and China, especially in the small countries in the Pacific, has been particularly helpful to those with ties to Taiwan. As the experience of the last few years has shown, Taiwan has become a reliable source of foreign funds for countries it has diplomatic ties to, and the Republic of the Marshall Islands has benefited from this diplomatic tug of war. Also, since the RMI's economy is small, even small amounts of increases in spending would show up in its total output.

In 2006, the RMI's population was an estimated 56,242, up 10.6 percent from 50,840 in 2000. Population growth in the RMI, as in the FSM, has moderated from high rates in recent years, mainly as a result of migration, rather than a drop in the natural rate of increase. Without migration, population growth rate in the RMI has recently been as high as 3.5-4.5 percent a year, among the highest in the developing world.

As with the FSM, the amended Compact with the RMI places greater and more explicit emphasis on expanding the productive capacity of the economy through private sector growth through fiscal year 2023. This is to take place mainly through improvements in public health, public education, public infrastructure, public sector capacity building, support for the private sector and the environment and institutional reforms that would make the RMI a more attractive market to overseas capital. Public Law 108-188, section 140(h)(1) requires this annual economic and financial report on the RMI by the United States Government. It provides information on, among other things, the use and effectiveness of United States financial, program, and technical assistance; the status of economic policy reforms; and the status of the efforts to increase investment.

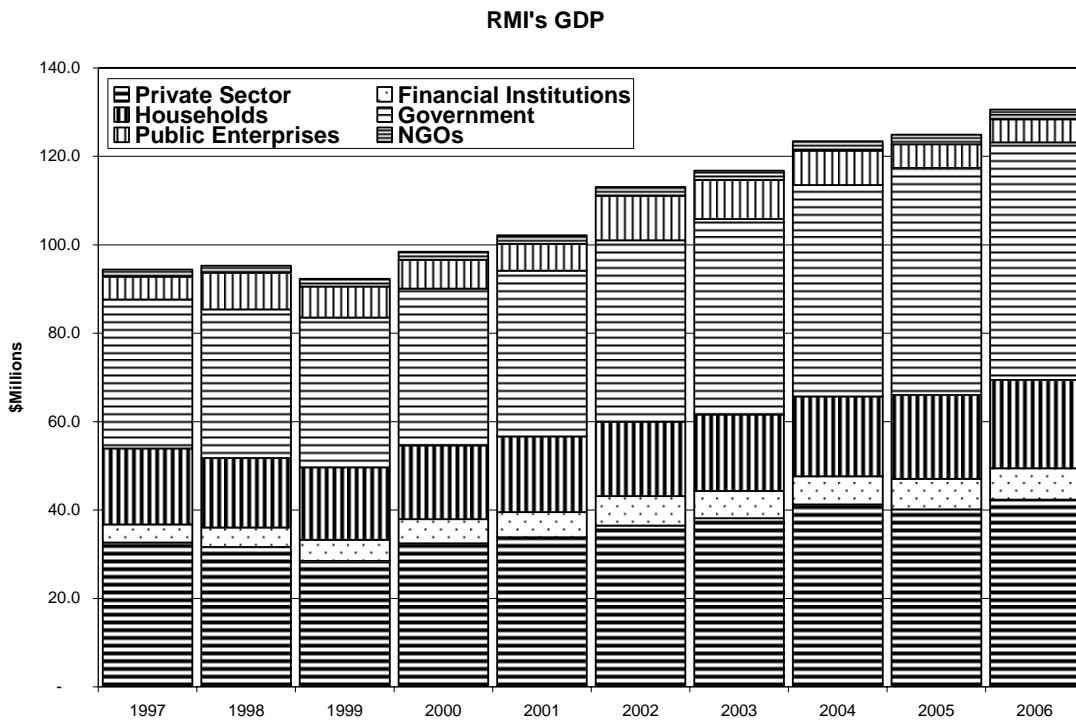
As in the case of the FSM, U.S. grant assistance drops by a certain amount every year through fiscal year 2023. To compensate for this reduction, the RMI government will have to make the necessary adjustments in its budget proposals to the Joint Economic Management and Financial Accountability Committee (JEMFAC). At the same time, the RMI government may find other sources of income such as taxes and fees in its private sector, especially if it is expanding, or other foreign funds to make up for the decrements in grant assistance from the United States. With 17 years of reliable operational grant and trust fund deposits from the United States, the amended Compact offers the people of the RMI a horizon of sufficient length in which to lay the foundation of the post-Compact RMI economy that would rely more on the private sector and less on the public sector and foreign assistance.

Economic Review of the RMI

As pointed out earlier, the RMI's economy has performed more favorably in the last seven years, as compared to that of the FSM's. According to the RMI government, real (adjusted for inflation) GDP increased every year in 2000-2006. Real GDP growth rate averaged a respectable 3.7 percent a year, ranging from a low of 1.1 percent in 2005 to a high of 6.5 percent in 2000. What is noteworthy about the composition of the RMI's GDP is the slow but steady rise of the public sector's share of total output which has been the main cause of growth. In 1997, the first year of the new GDP series, total public sector (government and public enterprises) was 38.6 percent of total output. In 2006, it was up to 42.5 percent. Total private sector (private sector, financial institutions and households) was 53.7 percent in 1997. It went down to 50.1 percent in 2006.

These changes in the relative shares of the public and private sectors, although not very large, signify a trend that is not only unhealthy for the overall economy, but eventually unsustainable. Between the Compact grants and grants from other donors, the RMI government increased spending, in both dollar amounts as well as share of the economy, almost every year in 1997-2006, providing the fuel for the economy to go into higher levels of output. During the same time, the share of the private sector decreased, sometimes by small amounts. The private sector and the public sector moving not only in opposite directions but out of phase with market economies holds the potential for disruption in economic growth and the average standard of living.

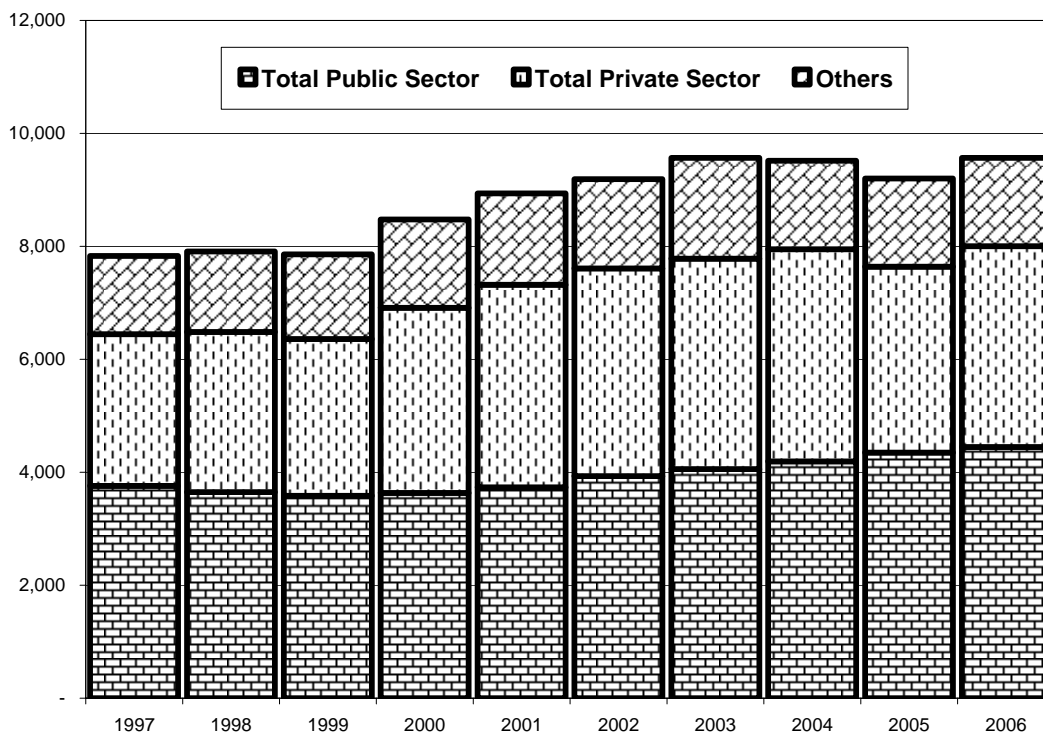
Real per capita GDP in 1997 was \$2,077, reached a high of \$2,182 in 2004, declined slightly to \$2,172 in 2005 only to go back up to \$2,180 in 2006. In comparison to the FSM and other small economies of the Pacific, the RMI's real per capita GDP growth is impressive. It is one of a few economies in the region to have experienced real per capita GDP growth for several consecutive years. However, once again, this growth has been made possible by increases in public spending, rather than private-sector gains. This trend of the public sector supporting the private sector, the opposite of market economies, and generating gains in the standards of living is unsustainable. The question is when, not whether, the public sector would reach its peak capacity to spend and sustain the economy. Once that point is reached, the consequences can be painful, economically and financially for the RMI and its citizens. Again, as with the FSM, migration to the United States and its territories provides a major safety valve for the RMI's economy and its ecosystem, but all Marshallese citizens would not be expected to migrate. Those who stay behind will have to work within the economy they would have, which makes the case for a stronger private-sector economy more urgent.



A U.S. military installation, especially with important strategic mission and assets, undoubtedly is an important source of income and sustenance, especially for Kwajalein and its neighbor, Ebeye. However, it is limited in its scope of work and its economic and financial reach throughout the RMI. With only 10-15 percent of the RMI's work force employed at the base, the need to find other sources of income and work is critical.

Payroll employment data show patterns similar to those of GDP. Total public sector employment, which includes the RMI government, local government, public enterprises and government agencies, has consistently dominated employment since 1997. Ranging from 41.7 percent to 48.0 percent, total public sector employment averaged 44.7 percent of total in 1997-2006. Total private sector employment, which includes private industry and banks, ranged from a low of 34.3 percent to a high of 40.2 percent in 1997-2006. It averaged 37.6 percent during the same period. An important point about the private sector employment pattern is that it has trended upward during the period. However, the upward trend in the private sector employment has been so slow and erratic that it would take a very long time to make a significant difference in the overall employment picture.

Payroll Employment by Sector



Other employment, mainly at the U.S. military installation on Kwajalein, remained stable over the 1997-2006.

The average rate of earnings reflects the relative strength of the public sector over the last several years. In fiscal year 2005, for instance, the average private sector earnings, as reported to the RMI Social Security Administration, were about half of those in the public sector. This trend has changed little over the last several years. In 2005, the average annual wages in the private sector were \$6,232, as compared to \$11,394 for the public sector as a whole. Within the public sector, government agencies paid the highest

wages, \$13,320 a year, followed by the RMI government with \$12,830, public enterprises with \$11,207 and local government with \$7,711.

Among the peculiarities of the RMI's labor market is the ratio of payroll employment to total population. In economies such as the United States, for example, just about half of the population is payroll employees, that is, persons who work for pay for others. In the United States and other industrial countries, this trend tends to be stable, although it is different in different countries. In the developing world this trend changes with the degree of development and work opportunities outside home and subsistence. As countries advance, their employment-to-population ratios rise. In the RMI, as in the FSM, the ratio has not only remained remarkably stable, it is also quite low. A low ratio such as that for the RMI, 17.0 percent in 2005, normally suggests the country is a developing economy where the majority of the labor force does not necessarily work for pay outside the home and the subsistence economy.

The RMI may be a developing economy, as measured by per capita GDP of \$2,466. However, it is not a developing economy in the sense that its economic output mix is changing much. The RMI economy today is much the same as it has been for the last 20 years which is based on outside flows of funds for sustenance. A low employment-to-population ratio is more a reflection of its institutional structure than the state of its development. A low employment-to-population ratio is not only an unfavorable development for today as fewer payroll workers have to support more people, it has the potential to become a serious problem in the future. Among the economic issues that deserve urgent consideration is this low employment-to-population ratio and remedies within the structural and institutional constraints of the RMI. One way to address this issue effectively is to focus on efforts that would expand the private sector and reduce the role of the public sector, within reasonable limits of time so as to diminish the disruptive effects on the economy and the labor market.

Another problem the RMI government and business have to confront is the relatively high rate of unemployment. Based on informal estimates made by the RMI's Economic Policy, Planning and Statistics Office (EPPSO) for 2004, the unemployment rate was an estimated 33.6 percent. The subsistence economy accounts for a small part of the total economy, averaging 6.1 percent of GDP through 1997–2004. Even after accounting for the subsistence economy which meets a part of household demand for food and provides some work, the rate of unemployment remains high.

Prospects for Private-Sector and Economic Growth

In light of the enduring constraints of land, minerals and other resources typical of land-based economies, the RMI should focus on its most significant comparative advantages embedded in its living ecosystem. These are, for now, fishing and fish processing and tourism. Local handicrafts have a certain potential among visitors. The RMI and other Pacific economies have been selling fishing rights to foreign fleets for decades, but they receive modest sums of money and almost no local value added other than purchase of

fuel and supplies from local vendors. There have been anecdotal reports of fishing fleets avoiding buying fuels in the local markets because of high prices.

Production of copra, the dried white flesh of a coconut, continues. However, its relative share as a part of the local production economy will continue to decline as other activities present more attractive options, especially to those with education and skills.

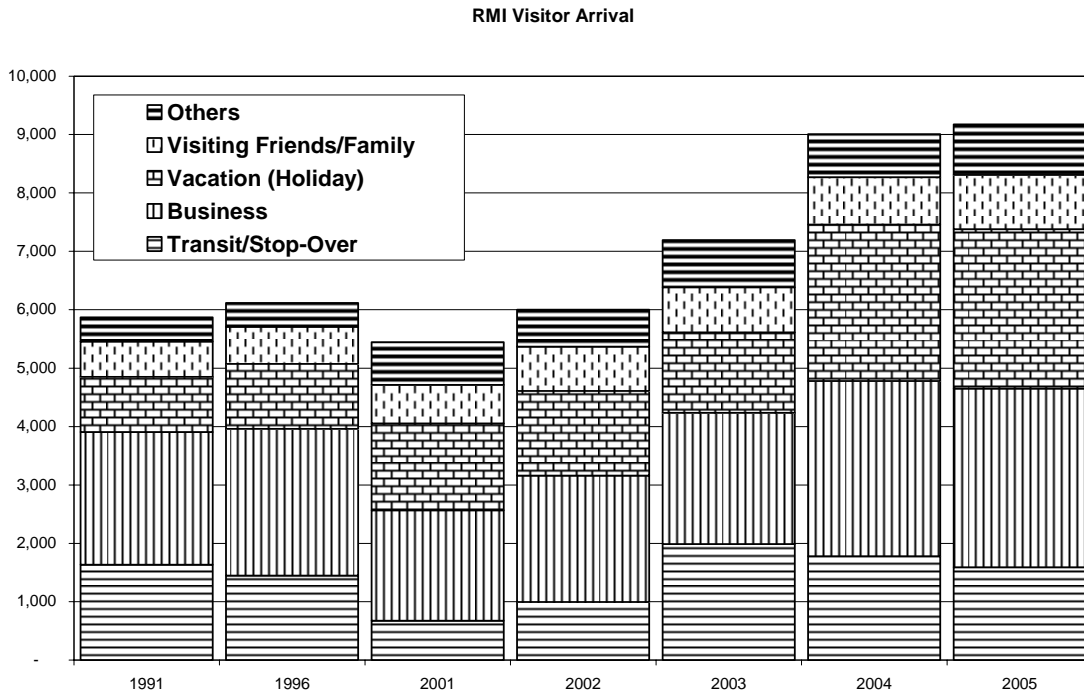
Tourism holds potential, particularly in specialty areas such as diving, sports fishing and other forms of recreational activities, such as boating, that take advantage of the Pacific Ocean. There may be cruise ship possibilities in the future. Business and government travelers provide another market. The Compact provides that, for purposes of Internal Revenue Code section 274(h)(3)(A), the RMI is included in the “North American Area” for purposes of the allowance of deductions for foreign conventions. Deductions for foreign conventions, meetings, or seminars are otherwise generally disallowed under the Internal Revenue Code, unlike events occurring in jurisdictions included in the “North American Area.”

Tourist traffic data compiled by the Marshall Islands Visitors Authority (MIVA) illustrate the potential of tourism as a future income source, notwithstanding its smallness today. In 1991, 5,872 visitors arrived in Majuro, the RMI’s capital and the only atoll connected directly to the outside world by regular commercial air service. A decade later, the total was slightly lower, perhaps because of the impact of terrorist attacks on the United States which dampened tourist traffic throughout the Western Pacific. Arrivals increased moderately in 2002 to 6,002 and a bit more in 2003 to 7,195. In 2004, the total reached 9,007, 25.2 percent higher than in 2003 and 53.4 percent higher than in 1991. In 2005, the total was up yet again to 9,173, a sign signaling a certain degree of consistency of increase, especially during the 2001-2005 period.

The more remarkable aspect of the increase in tourist traffic has been the gain in vacation travelers.. In 2001-2005, all visitors increased 68.5 percent from 5,444 to 9,173. During the same period, vacation travelers increased 83.9 percent, from 1,483 to 2,727. In the context of tourist traffic data, a few years hardly constitute a trend, but the relatively steady increase of vacation travelers in 2001-2005 suggests that there is room for growth. That Majuro has a number of regionally competitive hotel rooms and other visitor facilities such as restaurants should make it easier to sell the destination.

In late 2006, the RMI government announced that it had reached an agreement with Japan Airlines (JAL) for charter flights from Tokyo to Majuro, starting in early 2007. JAL flights to Majuro would be seen as a major milestone in the evolution of the RMI’s tourism industry. The flights will be seen both as an economic and symbolic achievement for the RMI. Economically, Japanese tourists are among the most desirable in the region because they tend to spend more money per person than most other tourists in places they visit. Even if Japanese tourist numbers are small initially, their spending would certainly make a difference in the local market which is also small. Symbolically, flights by JAL to Majuro would put the RMI on the region’s travel and leisure map. It is possible that Japanese traveling to the RMI would have specialized interests in, say,

diving, exploring World War II ship wrecks and other such activities. Still, any number of travelers from an important regional market to the RMI would be a signal of a more promising future in regional tourism. It would benefit one of the region's destinations that needs to be discovered by more travelers.



Another important project announced by the RMI government in late 2006 was to take advantage of the country's other major natural resource, fish. In fact, this will be the RMI's second attempt to extract greater economic value from the fish in its waters. With the closing down of the RMI's first fish processing (loining) plant in 2004 that employed as many as 300 workers and struggled to stay open during its short life, questions arose whether there was a way to exploit the country's most abundant ocean resource. In fact, the closing of the facility raised questions about the RMI's ability to put to commercial use a resource its people have used as a food source throughout history. The announcement said that a new, larger processing facility would be set up which would employ as many as 500-600 workers. It would commence work in early 2007. With about twice the number of workers as the first one, the new fish processing plant would also require a much larger initial investment, estimated to be around \$60 million.

Few details have been available since the announcement was made in November, but it was, just as the arrangement with JAL, an important future project that would have both economic and symbolic value to the RMI. The economic value of what will be the largest private-sector employer in the RMI will be quite significant. A plant that would employ 600 workers will create supply-chain reaction that, in the end, will be much more than either the payroll or total sales of the plant alone. It would involve local buying

power for those who work directly at the plant and that created by suppliers and other service providers connected to the facility. The final total effect on the RMI economy would be much greater than the compensation of 600 workers.

These two initiatives show that the RMI government is making a concerted effort to find income sources that would complement Compact funding and U.S. military outlays. If these ventures succeed, they will be seen as a concrete contribution to the efforts towards building that more self-reliant post-Compact economy.

Apart from the production and distribution possibilities within the indigenous economic base are the RMI's most valuable physical assets, its location and strategic ties to the United States. The RMI's contribution to United States strategic assets and facilities is a valuable comparative economic advantage that has been successfully translated into a reliable income stream. The amended Compact offers an additional significant advantage to RMI citizens, the right to travel to and reside and work in the United States. Also, more islanders living in the United States at some stage can become a valuable source of income as they may send money home to relatives.

Migration to the United States and its territories will continue in the years ahead, even if local economic conditions improve. Among the peculiarities of island economies, in the Pacific as elsewhere, is, that they cannot benefit from trade in goods as large economies can. Instead, they engage in trade in labor, but it usually takes place in one direction, from the islands, especially to developed economies where there are more work and study opportunities. The phenomenon often labeled "brain drain," the flight of motivated and skilled labor to advanced economies, is a natural extension of the principle of trade that happens to involve people.

As a growth and development tool, trade in goods works better for large economies, such as Mexico and, more recently, China. Even with rudimentary production skills, Chinese workers have increasingly engaged in the production of a wide variety of goods for export to rich countries, especially the United States. Manufacturers of basic goods have moved their operations from rich countries to China, for instance, mainly because of low cost of labor. Meanwhile, the foreign exchange the exports bring to China is a major source of income and domestic savings, so much so that some of it ends up funding international debt, including that of the United States. As Chinese workers improve their production and distribution skills, they gradually move from basic manufacturing to more advanced work, with increasingly larger knowledge content that generates greater value added. As these skills become more advanced and more widespread through industries and regions in China, for example, they lift the whole economy. India is now becoming a major supplier and exporter of high tech and high knowledge content goods and services and just, as in the case of China, this particular export and the foreign exchange India earns from it lifts the whole economy.

By contrast, small economies of the Pacific with small landmasses and populations cannot benefit from trade in goods as large economies can. The constraints citizens of small economies have to work with force some of them, especially those with skill and

the potential to make a living elsewhere, to engage in trade in labor (migration). The luxury the RMI (and FSM) has is that its people can travel to and reside and work in the world's most dynamic labor market, the United States. However, not all of those who want to work, with basic or advanced skills, would leave the islands. And those who stay need to have an economy that will support them. Once again, the only answer to this ongoing quandary is to start building that post-Compact economy of the future now.

With more stringent financial resource allocation controls guiding the amended Compact, the RMI's financial situation has the potential to improve and the RMI government has made financial stability a main objective. The JEMFAC, on which the United States has the majority vote, can play an instrumental role in both allocating and managing United States assistance in a manner that reduces misallocation. With financial controls in place, it is expected that increased benefit from Compact funds will accrue to the people of the Marshall Islands over the next 17 years.

(B) Use and Effectiveness of United States Financial, Program and Technical Assistance Funds

The FSM and the RMI receive significant financial, program, and technical assistance support from the United States Government. The amended Compacts provide the largest proportion of assistance through sector grants, trust fund transfers and other support, but the two governments also receive annual program support from a variety of Federal agencies. In addition to administering Compact funds, the United States Department of the Interior continues to provide discretionary grants for technical assistance, operations and maintenance of public infrastructure, and to protect coral reefs.

The Office of Insular Affairs has had difficulty with measuring the overall effectiveness of financial assistance to the FSM and the RMI. This difficulty stems from the absence of current and complete data from the FSM and RMI governments, which impedes our ability to monitor economic and financial performance on a recurrent basis. In the FSM, for the third consecutive year, correlations between budgets, national strategic outcomes, and sector goals are unclear. Most FSM budgets also lack quantifiable annual performance targets.

Compact Sector and Supplemental Education Grants

In fiscal year 2006, the United States Department of the Interior managed in excess of \$148,727,048 in Compact sector grant funds. Of that total, the RMI received an inflation-adjusted amount of \$35,143,528. The FSM's inflation-adjusted portion of \$113,583,520 included six new grants and fiscal year 2004 and fiscal year 2005 infrastructure grant funds that were de-obligated and re-awarded in fiscal year 2006. Not detailed here are the FSM's and the RMI's fiscal year 2004 and 2005 carryover sector grant allocations. These amounts remain available until expended by the countries and restricted to purposes for which the grants were originally awarded.

As mandated by the amended Compacts, funding for both countries continued to target a limited array of government sectors and, within those sectors, only specific aims to achieve enhanced accountability, safeguard the effective use of funds, and strengthen the foundation needed for economic stability and future growth:

Education: Education sector grants are to support and improve the educational systems of the governments and develop the human and material resources necessary for the two governments to perform these services. The amended Compacts require that funding allocations emphasize: (1) the advancement of a quality basic education system by increasing primary and secondary student achievement as measured by performance standards and assessments appropriate to the two countries; (2) the provision of secondary education or vocational training to qualified students; (3) the improvement of management and accountability within the educational systems; and (4) raising the level of staff quality and improving the relevance of education to the needs of the economy.

Health: Health sector grants are to support and improve the delivery of preventive, curative, and environmental health care, and develop the human and material resources necessary for the two governments to provide health services. The sector's priority is the establishment of sustainable funding mechanisms for operating community-based systems with emphasis on prevention, primary care, mental health and substance abuse prevention, and the operation of hospitals and dispensaries (clinics) to provide secondary care at appropriate levels and reduce reliance on medical referrals abroad.

Public Infrastructure: The highest priority funding uses for grants in this area are for primary and secondary education capital projects and projects that directly affect health and safety, including water and wastewater projects, solid waste disposal projects, and health care facilities. Secondary priorities are projects related to economic growth and development. Examples include airport and seaport improvements, roads, sea walls, and energy development that cannot be funded through existing rate structures.

Private-Sector Development: Private-sector development grants support the efforts of the two governments to attract new foreign investment and increase indigenous business activity by revitalizing the commercial environment; ensuring fair and equitable application of the law, promoting adherence to core labor standards, and maintaining progress toward the privatization of state-owned and partially state-owned enterprises, and, engaging in other reforms. Grant priorities include advancing the private development of fisheries, tourism, and agriculture; employing new telecommunication technologies, and, analyzing and developing new systems, laws, regulations, and policies that foster private sector development, and to develop business and entrepreneurial skills.

Public-Sector Capacity Building: Public-sector capacity building grants are to support efforts of the two governments to build effective, accountable, and

transparent national and local governments and other public sector institutions and systems. Funding priorities are to improve economic planning, financial management, auditing, law enforcement, immigration controls, the judiciary, and the compilation and analysis of appropriate statistical indicators. The goal is to ensure that both governments have the means to carry out essential functions and fill essential positions with qualified personnel.

Environment: Environment sector grants support government efforts to protect the countries' land and marine environment and to conserve and achieve the sustainable use of natural resources. Allowable activities include the ongoing development, adoption and enforcement of policies, laws and regulations; the reduction and prevention of environmental pollution and degradation; the protection of biological diversity; the establishment of conservation areas; environmental infrastructure planning, design construction and operation; interaction and cooperation with nongovernmental organizations; the promotion of increased environmental awareness; and, the promotion of increased citizen involvement in conservation.

In addition to the sector grants described above, Supplemental Education Grants (SEGs), first funded in fiscal year 2005, support the educational objectives of each government's Development Plan. The SEGs replace certain categorical grants previously provided by the Departments of Labor, Health and Human Services, and Education for which the FSM and RMI were eligible. Different from sector grants, the SEGs are subject to an annual appropriation from the U.S. Congress. These adjunctive grants do not supplant basic sector grant funding; nor do they satisfy the priorities mandated by the amended Compacts. Fiscal year 2006 marked the first full year of grant funding, using fiscal year 2005 funds.

Fiscal Year 2006 Sector Allocations for the FSM

The following is a breakdown of grant allocations to the FSM by sector, and within sectors, by government entity:

| | Education | Health | Capacity Building | Private Sector | Environment | Infrastructure |
|--------------|-------------------|-------------------|--------------------------|-----------------------|--------------------|-----------------------|
| National | 4,151,081 | 764,383 | - | - | - | 58,703,993* |
| Chuuk | 9,432,618 | 6,292,745 | 2,724,099 | 1,498,616 | 792,428 | - |
| Kosrae | 2,412,498 | 1,763,553 | 1,346,976 | 606,029 | 335,240 | - |
| Pohnpei | 6,978,447 | 4,898,393 | 759,254 | 887,817 | 665,807 | - |
| Yap | 3,149,415 | 2,675,865 | 1,345,585 | 1,046,701 | 337,977 | - |
| Total | 26,132,059 | 16,394,939 | 6,175,914 | 4,039,163 | 2,137,452 | 58,703,993 |

* Combination of 2004-2006 funding

Education

Most FSM states aligned their goals with the following five education goals cited in the FSM Strategic Development Plan:

1. Improve the quality of learning in the FSM.
2. Improve the quality of teaching in the FSM.
3. Consolidate performance monitoring and data based decision-making systems.
4. Strengthen participation and accountability of the education system to communities.
5. Ensure education is relevant to the life and aspirations of the FSM people.

The FSM National Division of Education focused on teacher certification and the national education strategic reform plan. New national standards and benchmarks were developed in mathematics, science, English language arts and vernacular language arts. The nationally funded College of Micronesia-FSM (COM-FSM) met U.S. accreditation requirements, including renovation of Chuuk campus facilities, communication improvements across and between all campuses, and development of a COM-FSM Strategic Plan 2006-2011.

Under new educational leadership, Chuuk made progress addressing needs cited in its Education Reform Plan, and responded to federal concerns regarding the secondary schools nutrition program, such that Compact funding for that activity was restored. New student and teacher desks and chairs were ordered and distributed to some schools. English language arts and mathematics textbooks were ordered; English language arts materials were received and distributed to all schools. Teacher training on the new materials was conducted.

Kosrae maintained its focus on teacher certification and only 15 of 196 teachers now lack a minimum AA/AS degree. Site-based management was implemented, enabling principals in the seven public schools to have control over their budgets for the first time. The Early Childhood Program expanded from one Head Start program to all six public elementary schools. Pohnpei continued a leadership training program for principals, and met the mandate that all secondary teachers must possess a BA degree. Pohnpei was the first FSM state to welcome Peace Corps and World Teach volunteers into the schools, and to complete a multi-year textbook purchasing plan. Half of Yap's teachers lack an AA or AS degree and struggle to obtain on-line and other courses that will lead to certification of their geographically dispersed teachers. Like all FSM states, Yap commenced textbook purchases, although distribution to schools was delayed due to shipment delays.

The FSM continued to provide performance data of varying quality. Only 16 of 20 indicators of educational progress were submitted; however, this information allowed preliminary comparisons to be made among the four states and against last year's

baseline data. Difficulties collecting, verifying and analyzing data at the state and national levels were acknowledged by FSM officials.

Fiscal year 2006 Supplemental Education Grant funding to the FSM supported the nation's five strategic goals. The grant award was released late in the fiscal year due to the late enactment of the fiscal year 2006 appropriation, logistics issues regarding the transfer of funds from the U.S. Department of Education to the Department of the Interior, and the late submission by the FSM of its plans for the use of the SEG funds. The delays caused hardship to some education programs.

Health

The FSM received a total Compact health sector grant of \$16,394,939 for fiscal year 2006, approximately \$1 million less than the previous year's award. Although analysis shows this funding level represented a growth of 6 percent from fiscal year to fiscal year, the increase was not evenly applied among the four FSM States and the National Government.

The budgets of Chuuk, Kosrae, and the National Department of Health, Education and Social Affairs increased while sector funding decreased significantly for Pohnpei and Yap. This variability arose from competing financial support needs within the states and different budget formulation policies and priorities, and did not translate into more health care improvements in the states that received proportionately higher grant funding. Were it not for special health revenue accounts used by Pohnpei and Yap to supplement their budgets during emergencies and shortfalls, these downward budget adjustments would have had a negative impact on areas such as utilities, communication, and pharmaceutical and medical supply purchases, recruitment and hiring, and equipment purchases.

As has been the case historically, health sector grant funding primarily supported regular recurring operations of in-patient facilities in the four states. It enabled long-neglected salary adjustments for some categories of health professionals, supported better managed tertiary medical referral management and care, facilitated the purchase of essential equipment, provided resources to hire staff to expand in- and out-patient service capacity and funded minor and emergency repairs.

For the hospitals, direct assistance enabled the improvement of supply inventories that alleviated, in the short term, chronic shortages and the restoration of minimally adequate diagnostic capacity. Pohnpei was able to equip and improve its dental facility, for example, but the service is vulnerable. Unless the FSM takes steps to ensure reliable inventory systems and procurement procedures, a supply of willing vendors, adequate facilities and equipment maintenance, and systematic recruitment, the dental program and other health care will likely deteriorate. The deficiencies cited above have already affected the ability of all health departments to execute sound spending plans and will continue to do so until remedied.

The lack of local revenue to replace decrements in Compact assistance will likely compromise the growth and future performance of the health departments in the near to medium terms. Almost none of the FSM's five health departments received general revenue support in fiscal year 2006. Compact assistance alone supported the operating budgets of Kosrae and Chuuk, and was the dominant source of revenue for Pohnpei and Yap. Other financial support came from U.S. grants, primarily for public health and prevention, the basic social services loan from the Asian Development Bank, small targeted foreign assistance, health insurance reimbursement, and very nominal service fees. For public health programs and services, Compact funds were not the budgetary mainstay but used to supplement the discretionary categorical grants long provided by the U.S. Department of Health and Human Services.

Despite the FSM Strategic Development Plan's espoused emphasis on primary health care, funding continued to follow the path of curative care. This was, in large measure, due to the continuing need to play "catch up" to normalize those services and programs that were adversely affected during the step down phase of the Compact's first financial assistance period. Public health and primary care received comparatively less attention, even though the population of the FSM is far-flung and still vulnerable to both infectious and debilitating chronic diseases.

Improvements to Chuuk's dispensary program, made possible by heightened policy attention and increased fiscal year 2006 Compact funding to targeted areas, were evident but problems remained with maintaining adequate drug and supply stocks, supervising health assistant performance and attendance, up-keep and repair of facilities, supporting transportation, and communicating with the outer islands. Yap, a state that once had a premier network of distant outposts until it fell victim to stepped-down funding at the close of the first Compact period, reestablished four health centers on Yap's main island. These newly opened and renovated facilities now serve as best-practice models of administrative support, staffing, in-service training, and community support.

Another of Yap's innovations has been its competitive department-wide quality assurance program that rewards unit performance on a quarterly basis and boosts employee morale. No other FSM health department has followed suit.

The overall impact of these service and organizational enhancements over the medium and longer terms depends on the safety and adequacy of the health sector's physical infrastructure. Facility repair, renovation, and construction that needed redress years ago are still issues. The likelihood of health projects receiving expedited attention and priority is not very high.

Public Infrastructure

The FSM received a public sector infrastructure grant of \$58,703,993 during fiscal year 2006. This was a combination of fiscal years 2004-2006 funding. Due to internal differences between the FSM National Government and the state governments regarding the process of project implementation and the inability to demonstrate how the funding

would be managed in a unified comprehensive method, funds were not approved for expenditure during fiscal year 2004 and fiscal year 2005.

In May 2005, the FSM National Government signed a contract with a professional architectural and engineering design firm to provide the FSM with expertise in managing the formulation and implementation of Compact funded infrastructure projects. Once again, due to delays resulting from internal differences regarding costing of projects and an apparent conflict of interest by the selected engineering design firm, no capital projects were completed during fiscal year 2006.

Projects approved for funding during fiscal year 2006 are as follows:

Education

| | |
|--|--------------|
| Utwe Elementary School (Kosrae) | \$ 1,665,959 |
| Lelu Elementary School (Kosrae) | 2,129,233 |
| Tafunsak Elementary School (Kosrae) | 1,190,199 |
| Kolonia Elementary School (Pohnpei) | 1,839,170 |
| Madolenihmw High School (Pohnpei) | 2,117,439 |
| Yap Early Childhood Education Center (Yap) | 1,885,014 |

Health

| | |
|---------------------------------------|--------------|
| Weno Wastewater (Chuuk) | \$ 8,561,032 |
| Pohnpei Water Well Drilling (Pohnpei) | 1,074,484 |

Public-Sector Capacity Building

The FSM received \$6,175,914 for the capacity-building sector. The amount, representing approximately eight percent of all direct Compact financial assistance in fiscal year 2006, was a proportionately larger amount than intended or foreseen by the negotiators of the amended Compact but necessitated by the FSM's apparent lack of local revenue to cover a range of government operations.

From the outset of the amended Compact, U.S. delegates to JEMCO made clear that the purpose of the public sector capacity building grant was to build capacity in certain key functional areas such as accounting, financial management, budgeting, auditing and law enforcement, rather than the maintenance of pre-existing capacity. The funds were not meant to subsidize general government operations. JEMCO recognized, however, that the FSM did not have sufficient local revenue to support certain key public sector functions. It found that preventing the use of public sector capacity grant money for pre-existing operating expenses had the real potential to reduce capacity in critical areas. JEMCO consequently allowed pre-existing operating expenses in core areas but with the proviso that the public sector capacity building grant be subject to a 5-year phase-out period.

As shown by the chart below, the FSM has maintained its targeted phase-out schedule and has begun to separate the grant into conforming and non-conforming amounts. In fiscal year 2006, the conforming use total was \$1,248,504. Non-conforming uses totaled \$4,927,410. Although the grant supports an assortment of true capacity building initiatives, these uses still have not been well articulated by the FSM states and there is no short-term or medium-term plan to guide how the sector grant should be best used.

| Year | Target | Grant Amount | Grant Amount non-conforming | Grant Amount Conforming |
|------|--------------|--------------|-----------------------------|-------------------------|
| 2004 | \$10,615,924 | \$11,662,846 | \$10,615,924 | \$ 1,046,922 |
| 2005 | \$ 8,492,739 | \$ 7,786,238 | \$ 6,181,645 | \$ 1,604,593 |
| 2006 | \$ 6,369,554 | \$ 6,175,914 | \$ 4,927,410 | \$ 1,248,504 |
| 2007 | \$ 4,246,370 | \$ 5,609,691 | \$ 3,766,169 | \$ 1,843,522 |
| 2008 | \$ 2,123,185 | | | |

Environment

The FSM received an allocation of \$2,131,452 for its environment sector. The grant continued to fund government operations rather than environmental projects. Each State received funding for an Environmental Protection Agency or similar agency with a like mission. Financial assistance also supported marine and forestry conservation efforts. Public education programs were a part of all programs funded under this sector.

The lack of national goals for the environment continued to hamper the evaluation of performance progress. Each state established its own strategic focus at the agency or office level and activities failed to reach overarching national goals for the sector. At its March 2006 meeting, the JEMCO received a report from OIA that the sector has no overarching goals or performance measures to guide funding at either the national or state level. The majority of funding has gone to personnel, with little left over for other needs. For most of the first two and a half years of the amended Compact, a number of funded offices were either under-performing or not performing, based on reported activities. A major contributor to inefficient program performance has been a lack of cohesiveness and responsible management within the sectors.

OIA consequently recommended that JEMCO take the following actions: (1) not allocate sector grant funding to these agencies in fiscal year 2007, unless sector grant proposals are submitted in project-based format emphasizing specific deliverables and measurable outcomes (a project-based budget format would include the following sections: Introduction, Objective, Work Plan, Budget, Outcome (Output), Value of the Project to the Sector, and Link to the Strategic Development Plan), and (2) not allocate Compact sector funding in fiscal year 2007 in the event offices cannot demonstrate project-specific outcomes (outputs), and (3) ensure that offices receiving fiscal year 2007 allocations must dedicate no more than 70 percent of their budgets to salaries and budgets.

JEMCO implemented these recommendations in its fiscal year 2007 allocation of grant funds.

Private-Sector Development

The FSM received an allocation of \$4,038,910 for its private-sector development sector grant. This amount funded the basic operations of a number of different agencies to increase tourism, promote agriculture, and support small business.

The lack of national goals for the private sector development sector grant continued to hamper the evaluation of progress. Each state established its own strategic focus at the agency or office level and activities failed to reach overarching national goals for the sector. At its March 2006 meeting, the JEMCO received a report from OIA that the sector has no over-arching goals or performance measures to guide funding at either the national or state level. The majority of funding has gone to personnel, with little left over for other needs. For most of the first two and a half years of the Compact, a number of funded offices were either under-performing or not performing, based on reported activities. A major contributor to inefficient program performance has been a lack of cohesiveness and responsible management within the sectors.

OIA consequently recommended that JEMCO take the following actions: (1) not allocate sector grant funding to these agencies in fiscal year 2007 unless sector grant proposals are submitted in project-based format emphasizing specific deliverables and measurable outcomes (a project-based budget format would include the following sections: Introduction, Objective, Work Plan, Budget, Outcome (Output), Value of the Project to the Sector, and Link to the Strategic Development Plan), and (2) not allocate Compact sector funding in fiscal year 2007 in the event offices cannot demonstrate project-specific outcomes (outputs); and (3) ensure that offices receiving fiscal year 2007 allocations must dedicate no more than 70 percent of their budgets to salaries and budgets.

Department of the Interior Discretionary Grants

The FSM continues to be eligible for the discretionary grant programs of the Office of Insular Affairs (OIA) of the Department of the Interior. Although the amended Compact provides significant operational support in health and education and provides funds for capacity building, the government still has special short-term needs that can be effectively addressed by OIA's programs.

In fiscal year 2006, OIA provided \$419,460 in operations and maintenance grants for infrastructure covering repairs, training, equipment purchases, and expert consulting services. The sum of \$693,231 was provided in Technical Assistance grants, including \$500,000 for the continued implementation of a national financial management system. Additional technical assistance funding was made available for an environmental assessment of a fiber optic cable project, medical, law enforcement and airport security operations. The FSM was also awarded two grants totaling \$158,175 from the Coral Reef Initiative grant program.

Fiscal Year 2006 Allocations for the RMI

The following is a breakdown of grant allocations to the RMI by sector and Compact of Free Association, Section 211-mandated funding:

| Sector | Funds Allocated |
|-------------------|------------------------|
| Education | 10,834,083 |
| Health | 5,597,181 |
| Environment | 202,480 |
| Private Sector | 361,943 |
| Capacity Building | 103,514 |
| Infrastructure | 12,495,679 |
| Total | 29,594,488 |

| | |
|--------------------------------|-----------|
| Ebeye Special Needs | 3,185,560 |
| Kwajalein Environmental Impact | 205,520 |
| Kwajalein Development Fund | 1,952,440 |
| Disaster Assistance Fund | 205,520 |
| Total | 5,549,040 |

Education

During fiscal year 2006, the RMI used Compact education sector funds to meet the following four elementary and secondary education goals and three post-secondary education goals:

1. Continue to improve the curriculum at all levels of education in the RMI
2. Improve the effectiveness of all education staff and teachers in the RMI for all areas of education.
3. Improve student performance and learning outcomes through improved program delivery and community involvement.
4. Provide financial assistance to qualified students to pursue educational opportunities.
5. Improve the college curriculum
6. Improve the college campus environment.
7. Provide a sustainable college development plan.

The RMI Ministry of Education (MOE) identified and purchased textbooks and supplies in coordination with curriculum revisions, which include recently implemented educational standards, benchmarks, and learning expectations. New English language arts and mathematics textbooks were distributed in grades K-8. Mathematics and science textbooks were purchased and distributed to the high schools. A multi-year textbook purchasing plan is now in place.

Training of teachers on the new teaching materials took place. Twenty administrators and managers completed an on-line master's degree in educational administration. Time clocks have been installed in all Majuro schools to address teacher absenteeism. Preliminary results from re-testing teachers on English language skills indicate some improvement in written English. Intensive summer English institutes continued for the second year. The MOE faces challenges since over 40 percent of teachers have only a high school diploma.

The third year of universal Kindergarten expanded the program to 61 schools. Fourteen schools remain to implement the program. The locally developed, criterion referenced Marshall Islands Student Achievement Test (MISAT) is aligned to the elementary level standards and tested students in grades 3, 6, and 8. The MISAT for grade 10 is under development.

The MOE improved its use of the RMI Performance Based Budgeting system. Ministry staff members are developing measurable goals for each indicator. For the second year, the MOE submitted data on 17 of 20 indicators of educational performance. Comparison can now be made with last year's baseline data. The need to clean and verify data received from schools is recognized as an MOE issue to address.

The College of the Marshall Islands (CMI) receives only three percent of Compact education sector funding. CMI made significant progress in addressing several accreditation issues. CMI was taken off "Show Cause" status and moved to "Probation" status. Marked improvements continue to be made addressing academic programming, faculty recruitment and retention, and delivery of student services. Several facility improvements are well under way.

Fiscal year 2006 Supplemental Education Grant funding to the RMI contributed to the seven goals cited. The grant award was again released late in the fiscal year due to late fiscal year 2006 appropriation, logistics issues regarding the transfer of funds from the U.S. Department of Education to the Department of the Interior, and because the RMI did not submit its plans for the use of the SEG funds until well into the fiscal year. The delays caused hardship to some education program.

Health

Compact funds provided approximately 38 percent of the total dollars available for health operations in fiscal year 2006. Although the Ministry of Health's basic health sector grant increased by \$741,221 over the previous year, this amount still did not make up for the \$1 million decline between 2004 and 2005, the first two years of the Compact as amended. Increased general fund and special health fund appropriations initially offset the negative impact this reduction in Compact sector grant funding would have had on keeping up with inflation and coping with the loss of actual dollars. A suspension in general fund spending midway through the fiscal year placed an unexpected added strain on the Ministry's overall budget and consequently on Compact resources.

While the Compact gives the RMI wide latitude in determining how and where to apply its grant resources, it stresses two specific objectives: (1) establish funding sustainability to operate community-based services and programs and hospitals that provide appropriate secondary care; and (2) reduce reliance on out-of-country medical referrals. Judged against these objectives, the performance of the Ministry of Health in fiscal year 2006 was mixed at best.

The Ministry began the process of analyzing expenditures associated with certain diseases such as diabetes but, to date, no attention has been given to revising the co-share fee structure that would enable the recouping of a greater share of money spent on health care. Costs are still heavily subsidized by employer-based social insurance payments, general funds, the Compact, and U.S. Federal grants. Although primary health care is the focus of the Ministry's strategic mission and viewed as the principal means to improve health status, funding still has not followed policy.

In fiscal year 2006, hospital-based outlays for recurring costs and improvements continued to outpace those for public health, prevention, and outer island primary care services. The RMI consciously chose to upgrade its secondary care facilities in Majuro and Ebeye. With these upgrades has come a concomitant need to spend to improve the quality of hospital services. The payoff has been service enhancements and greater attention to biomedical equipment acquisition that yield a broader range of services ultimately intended to reduce the country's reliance on expensive out-of-country tertiary care.

Medical referral management underwent important changes. The RMI paid off its debt to Hawaii hospitals, entered into more cost-efficient agreements with Manila health care centers, and improved case management. Its direct referral expenditures decreased from \$5,535,740 in 2000, to \$1,742,696 in 2004, and \$1,507,610 in 2005. Spending has become more efficient and better managed. While these efficiencies have been significant, improved diagnostic capacity paradoxically contributed to a higher number of patients sent out-of-country for specialized care. This trend of sending off more patients at less cost will likely continue until treatment and management capacity in Majuro and Ebeye become firmly established.

Compact grants did not affect primary care and public health outcomes to any significant degree in fiscal year 2006. For the most part, funds helped keep community-based disease prevention and control services stable. They were not applied in any new targeted fashion to address the nation's burdensome chronic and infectious disease profile of high rates of diabetes, cancer, leprosy, tuberculosis, and sexually transmitted disease; nor were they directed to support innovations that decrease teenage pregnancies or improve environmental safeguards to the spread of contagious disease.

The Ministry of Health continued to be a leader in implementing performance budgeting and monitoring in the RMI, and is just now reaping benefits in terms of increased accountability among managers and in information-led decision-making. Compact funds supported internal capacity building to determine the "measurability" of the outcomes;

establish timing targets and baselines; evaluate outcomes; and isolate and track progress in strategic areas such as hospital improvements and the delivery of preventive services and primary health care on Ebeye.

Public Infrastructure

The RMI allocated \$12,495,679 for infrastructure improvements and maintenance in fiscal year 2006. This allocation is consistent with the government's policy that at least 30 percent of all annual Compact grants be directed to infrastructure development. To guide project selection, the RMI continued to utilize a comprehensive Infrastructure Development and Maintenance Program (IDMP), with complete project descriptions, timelines, financial requirements and measurable project indicators. Education is the priority sector targeted by Compact infrastructure assistance and has also received the largest portion of infrastructure development and maintenance funding over the past three years.

RMI Infrastructure Development and Maintenance Program projects listed below are for the Health and Education sectors with fiscal year 2004-2006 funding. Projects are mostly multi-year and include construction, maintenance, and purchasing of equipment:

Rita Elementary School Phase I

Construction of two 4-classroom blocks - 240 students

Final cost - \$1,040,000

Completion date – August 2005

Laura High School Phase I

Construction of one 4-classroom block -120 students

Final Cost - \$605,539

Completion date – March 2006

Laura Elementary School (renovation)

Construction and retrofit 8 classrooms and a library space -240 students

Final Cost - \$204,193

Completion date – January 2005

Jaluit High School Phase I

Construction of two 8-classroom blocks and a dormitory – 240 students

Final Cost - \$3,000,000

Completion date – November 2006

Marshall Islands High School Phase I

Construction of one 8-classroom block – 240 students

Final Cost - \$1,250,000

Completion date - May 2006

Northern Islands High School Phase I

Construction of an administration building and a dormitory
Final Cost - \$974,313
Completion date – Substantially completed, awaiting power connection

Rita Elementary School Phase 2
Construction of two 4-classroom blocks - 240 students
Estimated Final cost - \$1,450,000
Estimated Completion date – February 2007

Marshall Islands High School Phase 2
Construction of three 8-classroom blocks and a 4 classroom block – 840 students
Estimated Final Cost - \$4,500,000
Estimated Completion date – September 2007

Namdrik Elementary School Phase 1
Construction of an eight classroom block – 240 students
Estimated Final Cost - \$885,511
Estimated Completion Date – May 2007

Rairok Elementary School Phase 1
Building structure retrofit and roofing repairs
Estimate Final Cost - \$626,548
Estimated Completion Date – April 2007

Jaluit High School Phase 2
Construction of staff housing, library, and various demolition works
Estimated Final Cost - \$1,850,000
Estimated Completion Date – June 2007

Northern Islands High School Phase 2
Construction of an 8-classroom block, staff housing, and dormitory renovation
Estimated Final Cost - \$2,800,000
Estimated Completion Date – October 2007

College of the Marshall Islands Capital Improvements - \$324,394

Majuro Hospital Equipment Purchase - \$1,898,537

Ebeye Hospital Equipment Purchase - \$570,000

Outer Island Dispensary Renovations - \$490,000

Majuro Airport Repaving - \$500,000 (Matching funds for FAA Airport Improvement Program)

Kwajalein Atoll Joint Utility Resources - \$1,238,710

The following table identifies the projects funded in each year, from fiscal year 2004 through fiscal year 2006:

| FY 2004 | <u>Amount</u> |
|------------------------------------|---------------------|
| Jaluit H.S Phase 1 | \$3,710,270 |
| NIHS | \$1,405,000 |
| Rita Phase 1 | \$1,200,000 |
| MIHS | \$1,832,500 |
| Laura HS | \$760,125 |
| Majuro hospital equipment | \$827,410 |
| OI dispensaries | \$490,000 |
| Ebeye Hospital equipment | \$570,000 |
| Ebeye professional housing | \$429,671 |
| Ebeye Power H2O | \$350,000 |
| CMI capital improvements | \$139,888 |
| CMI info network | \$184,506 |
| IMF | \$700,000 |
| | <u>\$12,599,370</u> |
| FY 2005 | |
| Rita Phase 2 | \$1,210,000 |
| Uliga Elementary School | \$3,695,732 |
| Marshall Islands H.S. Phase 2 | \$4,700,000 |
| Ebeye Elementary School | \$1,088,750 |
| Maintenance Fund | \$674,287 |
| Majuro Hospital Equipment | \$1,071,127 |
| Ebeye Sewer | \$288,710 |
| Ebeye Water | \$100,000 |
| | <u>\$12,828,606</u> |
| CSG-RMI-2005-INF-REPROG | |
| Majuro Airport Repaving | \$500,000 |
| Namdrik School Phase 1 | \$1,000,000 |
| Majuro Solid Waste | \$250,000 |
| Education Maintenance | \$507,769 |
| KAJUR RO Unit | \$45,000 |
| KAJUR Building | \$80,000 |
| KAJUR Generator Overhaul | \$200,000 |
| KAJUR Guggeegue Underground Power | \$175,000 |
| | <u>\$2,757,769</u> |
| FY 2006 | |
| Jaluit H.S. Phase 2 | \$1,335,563 |

| | |
|---|--------------------|
| NIHS Phase 2 | \$2,259,938 |
| Laura HS Phase 2 | \$1,067,175 |
| Ebeye Elementary School Phase 2 | \$1,380,000 |
| Kwajalein Atoll HS | \$2,162,424 |
| Rairok Elementary | \$1,719,975 |
| IMF | \$546,254 |
| Project Management, Administration, Engineering, Design | <u>\$2,024,350</u> |
| | \$12,495,679 |

Public-Sector Capacity Building

The RMI received \$103,514 in Compact funds to support the general operations of the Office of the Auditor General. No funds from this allocation were spent.

Private-Sector Development

The RMI received an allocation of \$361,943 for its private-sector development sector grant. This amount was used to support the following activities: trade and investment promotion, land registration, tourism promotion, and small business development.

- Trade and Investment Promotion: The Trade and Investment Unit focused on conducting trainings for new product developments with virgin coconut oil. Work also began on a website to display Marshallese product information. Outreach sessions were held with some of the foreign embassies in Majuro to develop product packaging specialized for target audiences.
- Tourism Promotion: The RMI has worked to reach potential clients through its Japan office which is partly funded with Compact funds. This year, the main focus of this effort was to promote and make arrangements for the start of a direct charter flights from Japan to Majuro. Staff worked to disseminate information about local products, tourism opportunities, and fisheries. Funds were also spent on traditional print advertisement and staff training.
- Small Business Development: The Small Business Development Center (SBDC) continued to conduct training and counsel clients on business development plans. The SBDC helped to initiate 22 new business loans, totaling more than \$95,000, which created 48 new jobs and retained nine current jobs. The SBDC also conducted 217 business counseling sessions, 21 training courses which 1,344 people attended.

Environment

The RMI received an allocation of \$404,720 for its environment sector grant. This amount was used to support the following activities under the RMI Environmental Protection Agency (EPA):

- Environmental Health and Water Quality: The RMI continued to collect and test water samples. In 2004, only 23 percent of the samples collected were deemed safe for drinking. In 2006, 620 samples were collected, with 37 percent deemed to be safe.
- Land and Coastal Management: The department continues to issue earthmoving permits and held public hearings for development permit requests. Work continues on coastal management plan development for out island communities.
- Biodiversity: In coordination with outside agencies, training was provided on invasive species management, conservation area development, and native species preservation.
- Solid and Hazardous Waste: Solid waste management continues to be problematic in Majuro. Several agencies with varying roles are responsible for managing solid waste on Majuro. A draft policy for solid waste management was published in fiscal year 2005; little to no action has come from the draft.
- Education and Awareness: Twenty-eight public education and awareness sessions were conducted with school and community groups. EPA implemented new environment curriculum in the schools and added 261 new publications to its library.

Department of the Interior Discretionary Grants

The RMI continues to be eligible for the discretionary grant programs of the Office of Insular Affairs (OIA). Although the amended Compact provides significant operational support in health and education and provides funds for capacity building, the government still has special short-term needs that can be effectively addressed by OIA's programs.

In fiscal year 2006, the OIA provided \$88,500 in Operations and Maintenance grant funding, \$50,000 for the Coral Reef Initiative, and \$735,053 from the Technical Assistance program. Technical assistance funding included \$390,000 to assist in the RMI fiber optic cable project.

Ebeye Special Needs

In order to advance the objectives and specific priorities of the community at Ebeye and other Marshallese communities within Kwajalein Atoll, grant assistance is made available on an annual basis to improve the infrastructure and delivery of services and develop the human and material resources necessary for the RMI to maintain such infrastructure and deliver such services.

The RMI received \$3,185,560 for Ebeye Special Needs for education and health uses in fiscal year 2006. The education sector applied its allocation of \$1.1 million to provide

basic primary and secondary services to Kwajalein Atoll students (\$1 million) and to support the Scholarship Board (\$100,000). The \$1,085,560 awarded to the health sector supported the recurring costs of Ebeye Hospital and Kwajalein preventive and primary care services, as well as covered operational improvements. Lastly, the RMI directed \$1 million to fund education and health infrastructure improvements.