Comm. #102

REPUBLIC OF THE MARSHALL ISLANDS

MINISTRY OF FOREIGN AFFAIRS

PO BOX 1349

MAJURO, MARSHALL ISLANDS 96960

January 11, 2018

Hon. Kenneth Kedi
Speaker
RMI Nitijela
Majuro, Republic of the Marshall Islands

Iakwe Mr. Speaker,

I wish to share a copy of the United States' Report on the Second Five-Year Review of the Compact, as Amended, including the Republic of the Marshall's comments and recommendations to this second five-year review.

Your kind assistance in sharing a copy of these documentations with members of Nitijela will be highly appreciated. Kommol tata.

Sinerely,

John M. Silk
Minister of Foreign Affairs & Trade

Attachments:
1. U.S. Second Five-Year Review of the Compact, as Amended
2. RMI recommendations and comments to U.S. Second Five-Year Review of the Compact, as Amended

Phone: (692) 625-2699/2763/3012/3181; Fax: (692) 625-4979; Website http//:www.rmiembassyus.org/

REPUBLIC OF THE MARSHALL ISLANDS
CONFIDENTIAL
C.M. 006 (2018)

FOR ACTION
Minister of Foreign Affairs and Trade
Minister-in-Assistance-to-the-President and Environment

FOR INFORMATION
All Ministers

SUBJECT: Endorsement for Kwajalein Atoll Local Government to utilize the remaining funds for the Causeway Maintenance Fund and the Ebeye Solid Waste Project Fund.

At its meeting on January 5, 2018, the Cabinet:

1) **endorsed** the use of the Causeway Maintenance Fund and the Ebeye Solid Waste Project Fund for Kwajalein Atoll Local Government operations; and

2) **authorized** the Minister of Foreign Affairs and Trade or his designee to proceed with this endorsement.

Hilda C. Heine, Ed. D
President

Earlie C. Bing
Clerk of the Cabinet

[Reference – C.P. 7790 (2018)]
Signed by the President on January 5, 2018.

Second Five-Year Review of the Compact of Free Association, as Amended, Between the Government of the United States and the Republic of the Marshall Islands

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
Amended Compact	—	Compact of Free Association Between the RMI and United States, as amended (entered into force May 01, 2004)
Amended Compact Act	–	Compact of Free Association Amendments Act of 2003 (P.L. 108-188)
CAP	—	Comprehensive Adjustment Program
CMI	—	College of the Marshall Islands
COFA	—	Compact of Free Association
Compact	—	Compact of Free Association Between the RMI and United States (entered into force October 21, 1986)
CPI	—	consumer price index
CTF	—	Compact Trust Fund
DMP	—	Decrement Management Plan
FPA	—	Fiscal Procedures Agreement
FSM	—	Federated States of Micronesia
GDP	—	gross domestic product
GRT	—	gross receipts tax
IMF	—	International Monetary Fund
JEMFAC	—	Joint Economic Management and Financial Accountability Committee
MEC	—	Marshalls Energy Company
MIDB	—	Marshall Islands Development Bank
MIMRA	—	Marshall Islands Marine Resources Authority
MTBIF	—	Medium-Term Budget and Investment Framework
NTA	—	National Telecommunications Authority
OIA/HFO	—	Office of Insular Affairs, Honolulu Field Office
PEFA	—	Public Expenditure and Financial Accountability
PFM	—	public financial management
PFTAC	—	Pacific Financial Technical Assistance Center
PNA	—	Parties to the Nauru Agreement
PSP	—	Public Sector Program
RIF	—	reduction in force
RMI	—	Republic of the Marshall Islands
RUS	—	Rural Utilities Service
SAFER	—	Sustainability Adjustment for Enhanced Reliability
SEG	—	Supplemental Education Grant
SOE	—	state-owned enterprise
TRAM	—	Tax and Revenue Reform and Modernization Commission
U.S.	—	United States

VAT — value added tax
VDS — Vessel Day Scheme

Note: The RMI government's fiscal year (FY) ends on September 30.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

EXECUTIVE SUMMARY

A. *Purpose of the Report*

1. This report is submitted pursuant to section 104(h) of Public Law 108-188, which calls for an annual report to Congress as well a review of the terms of the Compact of Free Association, as amended, between the Government of the United States and the Government of the Republic of the Marshall Islands (RMI) (Amended Compact) following the 5th, 10th and 15th anniversaries of its enactment. Public Law 108-188 was enacted on December 17, 2003, and the review covers the 10-year time period from FY2004-FY2013.[1]

2. As further specified by law, this report reviews the overall nature and development of the relationship between the United States and RMI, including: (A) general social, political, and economic conditions, such as estimates of economic growth, per capita income, and migration rates; (B) the use and effectiveness of U.S. financial, program, and technical assistance; (C) the status of economic policy reforms, including but not limited to progress toward establishing self-sufficient tax rates; (D) updates on efforts to increase investment, including the rate of infrastructure investment of U.S. financial assistance under the U.S.-RMI Compact, non-U.S. contributions to the trust funds, and the level of private investment; and (E) recommendations on ways to increase the effectiveness of U.S. assistance and to meet overall economic performance objectives, including, if appropriate, recommendations to Congress to adjust the inflation rate or to adjust the contributions to the Trust Funds based on non-U.S. contributions.

3. The review undertaken for this report was mandated to be conducted in a manner that would consider the operating requirements of the RMI and progress in meeting the development objectives set forth in the RMI's Medium-Term Budget and Investment Framework (MTBIF), in lieu of a development plan. The preparation of this report included discussions with the Government of the RMI to put forward their concerns, issues, and potential recommendations.

B. *Overview*

1. ECONOMIC DEVELOPMENTS

4. ***Economic Growth:*** During the review period (FY2003-FY2013) the RMI economy grew at an annualized rate of 1.8 percent, or 19 percent overall. Although this is a relatively modest rate, it is a satisfactory achievement for this small, remote, resource-scarce economy. During the initial years, economic activity was driven by public sector expansion, as the economy adjusted to larger grant flows than at the end of the initial Compact. While the economy experienced a negative period, reflecting the world economic financial recession in 2008, since then it has grown by 3.3 percent. The major drivers of growth have been fisheries, public administration,

[1] "Compact" refers to the original 1986 Compact, while "Amended Compact" refers to the 2003 Compact, as amended.

and education. In per capita terms, gross domestic product (GDP) grew by an annual average of 1.1 percent, less than GDP but reflecting the growth in population.

5. ***Migration, Employment, Inflation, and Wages:*** As the RMI's population has grown, there has been significant migration to the United States and its territories. Between 2004 and 2011, the rate of migration was 1.7 percent per annum, with a departure of 7,000 people. There are significant migrant communities now in Guam, Hawaii, Arkansas, Oregon, and other states. During the review period, the economy has generated a growing number of jobs, averaging 0.7 percent per annum, with 1.3 percent in the private sector and 1.7 percent in the public sector. However, the reduction in need for labor on U.S. Army Garrison Kwajalein Atoll (USAG-KA) incurred a loss of jobs equivalent to 0.3 percent per annum. Inflation averaged 4.1 percent during this period, which was higher than the comparable level in the United States of 2.4 percent. This was due to the higher weight of food and fuel in the RMI consumption basket. Wages grew by an annual average of 1.5 percent, indicating that real standards of living have fallen by 2.6 percent.

6. ***Fiscal Performance:*** Fiscal balance has generally been achieved during this period, with an average 1.1 percent of GDP. However, performance has been characterized by periods of weakness, especially during the financial crisis, as the economy peaked in 2008 and domestic revenues weakened. The RMI has no scope for deficit financing, and imbalances are unavoidably financed through incurrence of short-term liabilities. In the first few years after the Amended Compact came into force, expenditures grew rapidly, financed through expanding grant assistance from the United States and other donors. In the mid-2000s, sources of finance eroded, and expenditures have remained largely constant ever since. In more recent years the fiscal position has eased, financed through unconditioned budgetary support from the World Bank (WB) and the Asian Development Bank (ADB) as well as rapid growth in fishing fees.

7. ***External debt and state-owned enterprises (SOE):*** Operations of these enterprises and external debt remain significant. They were characterized as reaching stages that leave the RMI at a "high risk of debt distress" during recent International Monetary Fund (IMF) Article IV (economic monitoring and policy assessment) consultations. Nevertheless, external debt continued to decline as a percentage of GDP in FY2013, falling from a level of 72 percent of GDP at the start of the Amended Compact to 51 percent in FY2013. Debt servicing, both government and SOEs, represented 15 percent of general fund domestic revenues in FY2013. While external debt is falling, the issue of subsidies and capital transfers to SOEs remains a very significant fiscal concern and represented 24 percent of GDP in recent years. While the RMI has a substantial social commitment to disadvantaged communities in the outer atolls, which requires government subsidies, it also supports inefficient activities in the telecom, utility, and transport sectors which could benefit from reform and privatization.

8. ***Development of an RMI Decrement Management Plan (DMP):*** Development of a plan has dominated Joint Economic Management and Financial Accountability Committee (JEMFAC) meetings between the RMI and the United States in recent years. The focus on this highlights the need to develop a planned response to the annual decline in sector funding and lack of full inflation adjustment contained in the Compact, as amended. In July 2014, an RMI leadership meeting was held to develop a DMP. A series of measures were incorporated into the framework, comprising expenditure cuts, tax reform, regularization of a substantial portion of

fishing fee income into the annual budgetary process, decreases in subsidies to SOEs, and a reduction of special transfers to Majuro landowners. If implemented, the DMP should, over the remainder of the years during which direct U.S. financial assistance is provided under the Amended Compact, that is, until FY2024, help achieve a sustainable fiscal outcome, with a planned approach to service delivery, in the face of declining resources.

9. Effective implementation of the DMP requires clear, quantifiable benchmarks that can be monitored. While progress on expenditure cuts, appropriations for the Marshall Islands Marine Resources Authority (MIMRA), and tax reform can be easily validated, greater definition is required to monitor achievements in reducing both the landowner utility and SOE subsidies. The DMP provides an opportunity to implement the past reform commitments, comply with JEMFAC resolutions, and place a greater focus on sound fiscal management and planning.

2. The Policy, Regulatory, and Institutional Environment

10. ***Fiscal Policy:*** In the area of fiscal policy, the RMI has generally achieved fiscal balance, since the Amended Compact entered into force. However, the operation of fiscal policy has been tightly balanced, and the economic downturn associated with the financial crisis in late 2008 required day-to-day cash flow management. Payroll costs rose significantly at the start of this period, as funding levels increased and the reforms achieved at the end of the 1990s were undone. The external debt profile at the start of the review period was high and might have been considered at risk. However, progress has been achieved in bringing the debt-to-GDP ratio down. Long-term fiscal adjustment and reforms under the Comprehensive Adjustment Program (CAP) to address the mid-2000s' world economic crisis were not implemented once fiscal pressure moderated, despite the continuing need. The ADB Public Sector Program (PSP) was partially implemented, and reforms were undertaken at the Marshalls Energy Company (MEC). The Decrement Management Plan (DMP) was crafted in June 2014, and the initial requirement to "regularize" the MIMRA fishing fees into the budget was implemented. The RMI Social Security system faces a rapidly deteriorating financial position, with a fund that could collapse before 2024. Reforms to strengthen the viability of the fund have been proposed but have not been acted upon.

11. ***Macroeconomic Monitoring:*** At the start of the reporting period, the RMI produced a limited set of basic macroeconomic statistics upon which to assess economic performance. Since that time, with the help of U.S. technical assistance, the RMI has compiled a full set of major economic statistics on the following: GDP, employment, wage data, consumer price index (CPI), banking statistics, balance of payments, international investment position, external debt, and government fiscal statistics.

12. ***Public Financial Management:*** The RMI initiated a program to adopt the World Bank and International Monetary Fund (IMF) standard, Public Expenditure and Financial Accountability (PEFA), as a means to improving public financial management (PFM). Financial accountability has undergone a mixed experience, frequently dependent on the caliber of staff available. While audits are no longer qualified, the delays in the FY2011 through FY2013 audits indicates a lack of capacity in the Ministry of Finance. In the absence of any long-term planning framework, the Medium-Term Budget and Investment Framework (MTBIF) was intended as the guiding tool of policy and budgetary resource allocation. While the MTBIF was initially

prepared in 2003 to satisfy a requirement under the Amended Compact, in recent years it has not been maintained or used as an active tool of management. A system of performance budgeting was implemented with U.S. technical assistance, and some ministries—Education and Health—prepared performance budgets. However, the rest of the government has not moved to this system, and monitoring or assessment of performance do not meet minimum standards. Financial management information systems provide adequate accounting and audit data, but they do not provide a basis for performance management, fiscal statistics, or budgeting.

13. ***State-Owned Enterprises (SOEs):*** The SOE sector remains a considerable risk to financial management, with subsidies and capital transfers representing 24 percent of domestic government revenues. Efforts to reduce this high level have been made in many reform efforts, but no success has been achieved. Certain SOEs are tasked with social obligations to support disadvantaged communities in the outer islands, but the level of subsidies has been growing in recent years. Early reform programs entailed policy to divest SOEs in local shipping, public works, and utilities.

14. ***Tax Reform:*** Attempts have been made to reform the RMI's tax system but have not met with success yet. A value-added-tax (VAT) was introduced in the mid-1990s but was almost immediately repealed, due to a lack of implementation capacity. A tax reform initiative sponsored by the IMF was introduced more recently; however, it is still awaiting legislative consideration.

15. ***Private Sector Regulatory Environment:*** In general, little attention has been devoted to the private sector regulatory environment. No reforms have been implemented to improve the regime for private investment. Despite the lack of an enabling regime, significant foreign investment has been attracted in the fisheries. In the area of land reform, an ADB technical assistance initiated reforms that were subsequently enacted into law. However, the registration of land under the provisions of the act has been slow. The 2016 World Bank's "Ease of Doing Business Survey" ranks the RMI 140 out of 189 countries.

16. Overall, the policy, regulatory, and institutional environment requires significant attention, if the pace of economic development and growth is to accelerate. Despite these limitations, the RMI has achieved a degree of economic growth that would not have been expected for a remote and resource-scarce nation.

3. Compact Trust Fund

The RMI Compact Trust Fund (CTF): During the period of investment since the outset of FY2006, the annualized rate of return has been 6.21 percent, while the blended benchmark return was 6.82 percent. The estimated value as of June 30, 2015, was $265 million. Assuming that the pledged contributions from Taiwan continue, the fund would need to grow at 3.6 percent annually to achieve a level sufficient to provide the maximum allowable distributions under the Trust Fund Agreement. However, achieving such a level does not mean that the risks of subsequent periodic fiscal shocks are eliminated. Such risks result primarily from the fundamental reliance upon market returns, which carries with it volatility. In addition, certain aspects of the Trust Fund Agreement will require the attention of the CTF Committee, in collaboration with the U.S. and RMI Governments.

C. Recommendations

17. Six recommendations are made in the following categories: Making Compact Assistance More Effective, Trust Fund, Federal Programs, Technical Changes to the Fiscal Procedures Agreement, and Tax and Trade Provisions.

1. Making Compact Assistance More Effective

18. While we have robust macroeconomic data which informs decisions and provides some insight into the effectiveness of U.S. assistance, as noted by the U.S. Government Accountability Office (GAO)[2], the RMI has not developed adequate data and reporting systems to be able to demonstrate progress in the health and education sectors, where the bulk of Amended Compact funding has been expended. During the reporting period, there has been limited progress on increasing or initiating monitoring programs, including to record either results (outcomes) or deliverables (outputs). There is a need to ensure that health and education statistics and performance monitoring can be reliably used to inform monitoring, in the short term, by U.S. grant managers and to inform JEMFAC decision-making regarding the effective use of Compact Sector Funding and, in the long term, by the GRMI itself once U.S. direct assistance to these sectors ends post FY2023. JEMFAC could be made a more effective body by enacting the recommendation described below.

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

2. Trust Fund

19. ***Compact Trust Fund Level:*** Both Parties have expressed concern that the funding level likely to be achieved may not be sufficient to meet the needs of both Parties. The Trust Fund would benefit from actions by the original Parties to supplement the Trust Fund from all sources, including from other states Subsequent Contributors as well as from appropriations for compensation under Section 111(d) of the original Compact, or successor provisions under the Amended Compact Act, involving the tax and trade provisions of the original Compact. With the current framework provided for by the Trust Fund Agreement, external analyses have found a significant probably of a year in which no funds would be available for distribution. Some technical amendments may be desirable to better meet the objectives of the Original Parties after FY2023, and both Parties should consult on their respective objectives for the Trust Fund and the most appropriate path to achieving them.

[2] GAO-13-675. Micronesia and the Marshall Islands Continue to Face Challenges Measuring Progress and Ensuring Accountability (September 20, 2013).

- Recommendation No.2: Secure additional funding from the RMI; seek additional funding from other donors and other sources; assess the possibility of contributing unallocated (carry-over) sector grant funds into the Trust Funds; and

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

3. Federal Programs

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

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

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

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

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

    - The due date for the section 215 Annual Economic Report as specified in Article V(1)(d) should be changed from February of each year to the end of July each year. The current timeline is difficult to achieve, given the desire to use audited figures, other reporting requirements, and limited capacity.

    - The due date for the annual single audit as specified in Article VIII should be changed to be consistent with the federal Single Audit Act.

    - FPA Article VI, section 2, Program Monitoring, Performance Reports, and Records Retention, should be changed to specify that the fourth quarter report format covers the full fiscal year, and the due date should be changed from 30 days to 60 days after the end of the fiscal year.

5. TAX AND TRADE

22. The Compact Act of 1986 provided for potential compensation to the RMI of up to $20 million, with the possibility for $40 million more, if the government of the RMI could demonstrate adverse impacts on its finances and economy as a result of unilateral changes the U.S. Congress made to the tax and trade provisions in Title II of the original Compact. The Amended Compact Act of 2003 referred to that provision and carried it forward in section 108(b). In 2009, to evaluate the RMI's claim, the Department of State reconvened the Interagency Group (IAG) Congress had requested be convened after the RMI's first petition in 1991. The IAG concluded that the RMI had reasonably demonstrated net adverse impacts, offset by the value of additional U.S. federal programs and services provided, based on the loss of Title II benefits in making their request for $20 million in further compensation under Section 111 (d) of the Compact Act. Per the terms of the Amended Compact, the $20 million would be deposited into the Compact Trust Fund. In 2010, the Department notified Congress of the IAG findings. However, funds have not been appropriated to make such a payment.

I. Compact Framework

A. Broad Features of the Amended Compact

23. The Compact of Free Association began in 1986 following passage of U.S. Public Law 99-239 ("Compact"), and, per the agreement of the Parties, entered into force on October 21, 1986. The Compact itself had no date of termination and remains in force indefinitely subject to ongoing mutual agreement, unless otherwise specified by its terms. Many of the provisions in the original Compact have been reconfirmed or superseded by the terms of the Amended Compact, which entered into force on May 1, 2004, as mutually agreed. There are three broad features under the Amended Compact that provide the general framework for our bilateral relationship: (1) U.S. financial assistance, which includes both direct assistance as well as trust fund contributions; (2) immigration and migration privileges; and (3) unique security and defense rights and responsibilities. Under the Amended Compact, U.S. financial and economic assistance, as well as certain federal programs and services, is to be provided for a defined term, generally for a period of 20 years. Provisions related to immigration and migration, as well as certain provisions on security and defense matters, however, abide in perpetuity unless terminated or otherwise agreed.

24. Additional economic assistance was provided for under the Amended Compact, enacted through U.S. Public Law 108-188 ("Amended Compact"), which entered into force on May 1, 2004. The direct economic assistance provided under this Amended Compact covers the 20-year period from FY2004-FY2023.

B. U.S. Direct Economic and Financial Assistance

1. Mechanisms of the U.S. Direct Grant Assistance Under the Amended Compact (FY2004-FY2023)

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

i Section 211(f): RMI Medium-Term Budget and Investment Framework

26. Section 211(f) required a Medium-Term Budget and Investment Framework (MTBIF) to be prepared and maintained by the RMI on a multiyear rolling basis. There has been an annual effort to produce the MTBIF and a related effort to improve the performance orientation of the budget requests presented by the health and education ministries for Compact sector grant funding. During the period covered by this report, budget requests and MTBIF-stated priorities did not match the explicit rolling commitments of the MTBIF. In addition, budget justifications provided as part of the annual budget review process at annual JEMFAC budget consultations

were focused on emerging and contemporary priorities. However, in the FY2015 budget process—after the period covered by this review—there was a successful effort to reorient budget requests according to a decrement management plan that addressed the fundamental declining nature of sector funding during the Amended Compact. The MTBIF is reviewed in further detail below.

ii Fiscal Procedures Agreement

27. Although there were fiscal procedures that guided the transfer of funds to the RMI during the initial Compact period, they were limited to administration of the flow of funds and were not as comprehensive as those that came into force at the outset of the Amended Compact. The FPA has transformed the application of financial assistance to the RMI. Financial assistance during the Amended Compact period is provided through specific grants. The FPA is based substantially on the Common Rule, which guides the award and implementation of grants from the U.S. federal government to state and local governments.

28. Recommendation No. 5 of this review offers some changes to the FPA to be consistent with the federal law, and to better reflect the RMI's budget cycles and capacity.

iii JEMFAC

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

> (a) Review the medium-term budget and investment framework of the Government of the Republic of the Marshall Islands, and evaluate the progress made by the Government of the Republic of the Marshall Islands to foster economic advancement and budgetary self-reliance in relation to its written goals and performance measures;
>
> (b) Consult with providers of United States Federal Grant programs and services and other bilateral and multilateral partners to coordinate the use of development assistance from all sources as it relates to the allocation of financial assistance under the Compact, as amended;
>
> (c) Review Audits called for in the Compact, as amended, or this Agreement and actions taken or being taken to reconcile problems and qualified findings;
>
> (d) Review performance outcomes and other reported data in relation to the previous year's Grant funding levels, terms, and conditions;
>
> (e) Review and approve Grant allocations, performance objectives, and, where appropriate, assessment tools for the upcoming year;
>
> (f) Review and approve any change proposed by the Government of the Republic of the Marshall Islands to the sectors or other areas to receive economic assistance set forth in Title Two of the Compact, as amended;

(g) Evaluate progress, management problems and any shifts in priorities in each sector or other area, and identify ways to increase the effectiveness of United States assistance;

(h) Review quarterly trust fund investment reports;

(i) Comment on the comprehensive report prepared by the Government of the Republic of the Marshall Islands as required by section 215 of Title Two of the Compact, as amended, before it is submitted to the President of the United States; and

(j) Attach special conditions to any or all annual Grant awards to improve program performance and fiscal accountability, and ensure progress toward macroeconomic goals.

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

2. Federal Programs and Services

31. Through the Amended Compact (Section 222) and other relevant laws the RMI is eligible for additional federal programs and services. Between Fiscal Year 2009 and Fiscal Year 2013, the RMI has accessed an average of $9.2 million annually in additional U.S. federal grants and programs outside of the Section 211 Sector Grants, Section 212 Kwajalein Landowners, and Section 213 Audit. The programs were spread across several U.S. federal agencies: U.S. Department of Commerce, U.S. Department of Agriculture, U.S. Department of the Interior, U.S. Small Business Administration, U.S. Department of Homeland Security, U.S. Department of Education, and U.S. Department of Health and Human Services. These programs are found in the Catalog of Federal Domestic Assistance and are granted and administered as if they were operating in the United States.

3. Trust Funds

32. Under the Amended Compact, a Trust Fund for the people of the RMI was established. Contributions to the Compact Trust Fund by the U.S. and RMI governments are governed by the schedule in Section 217 of the Amended Compact. According to that schedule, the U.S. government is obligated to contribute $7 million annually from FY2004 to FY2023 plus a cumulative amount that increases by $0.5 million annually beginning in FY2005 until FY2023. This additional amount corresponds to the amount by which the U.S. direct sector grant assistance provided under the Amended Compact is reduced in that fiscal year. A two-thirds inflation adjustment is also added to the U.S. contribution amount as provided for under the Amended Compact. The RMI government was obligated to contribute at least $30 million in specific tranches by October 1 2005. U.S. contributions to the Fund were dependent upon these RMI contributions. Taiwan is a Subsequent Contributor, and committed to providing a total contribution of $40 million to FY2023.

C. *Military*

33. Under the terms of the Amended Compact, the RMI granted the United States full authority and responsibility for all security and defense matters in and relating the RMI in perpetuity unless terminated or otherwise agreed. This authority and responsibility includes an obligation to defend the FSM and its peoples from attack or threats thereof as the United States and its citizens are defended, strategic access to RMI's land and waterways, and a U.S. right to

deny access or use of RMI's territory to military personnel of third countries or for such countries' military purposes. The RMI also agreed to refrain from actions that the United States determines are incompatible with this authority and responsibility. Strategically, the RMI hosts the U.S. Army Garrison Kwajalein Atoll (USAG-KA) Ronald Reagan Ballistic Missile Defense Test Site, a key installation in the U.S. missile defense network. The amended Military Use and Operating Rights Agreement (MUORA) provides U.S. access to Kwajalein through 2066, with an option to renew until 2086.

D. Immigration

34. Under the Amended Compact, United States continued to grant RMI citizens permission to visit, live, and work in the United States visa-free, with additional clarifications on eligible individuals and applicability of U.S. immigration laws. The immigration provisions have no termination date. In previous studies the GAO estimated that one-fourth of all citizens of the Freely Associated States (including the RMI) reside in the United States. In addition, Congress has provided $30 million annually for affected jurisdictions through FY2023. The description of internal and external migration patterns provided in Section III indicates an out-migration rate of approximately 1.5 percent annually during the Amended Compact period. This implies the movement into U.S. territories, Hawaii, and the U.S. mainland of approximately 8,000 Marshallese during the period covered by this review.

RMI Comments

1. Tax and Trade

35. The Compact Act of 1986 provided for potential compensation to the RMI of up to $20 million, with the possibility for $40 million more, if the government of the RMI could demonstrate adverse impacts on its finances and economy as a result of unilateral changes the U.S. Congress made to the tax and trade provisions in Title II of the original Compact. The Amended Compact Act of 2003 referred to that provision and carried it forward in section 108(b). In 2009, to evaluate the RMI's claim, the Department of State reconvened the Interagency Group (IAG) Congress had requested be convened after the RMI's first petition in 1991. The IAG concluded that the RMI had reasonably demonstrated net adverse impacts, offset by the value of additional U.S. federal programs and services provided, based on the loss of Title II benefits in making their request for $20 million in further compensation under Section 111 (d) of the Compact Act. Per the terms of the Amended Compact, the $20 million would be deposited into the Compact Trust Fund. In 2010, the Department notified Congress of the IAG findings. However, funds have not been appropriated to make such a payment.

36. During preparation of this report, consultations with the RMI resulted in its submission, inter alia, of the following comments with regard to this issue:

> *The RMI Government submitted an assessment to the U.S. Government on the impact of the removal of the tax and trade provisions of the original Compact. The amended Compact carried forward the original Compact's language in Section 108 of PL 108-188, which permits submission of any claims before 30 September 2009. The RMI can receive $20 million, or up to $60 million given that*

the FSM Government did not submit its claim by the deadline. If compensatory adjustments are awarded, the funds will be contributed directly to the Trust Fund per Section 216(b) of the amended Compact. The RMI strongly believes funds received resulting from this Compact provision is one way to help strengthen the viability of the Trust Fund.

37. In addition, during preparation of this report, consultations with the RMI resulted in its government submitting comments, *inter alia*, regarding the following issues: (a) treatment of U.S. imports into the RMI (Most Favored Nation Clause); and (b) preferential access of RMI goods to the U.S. market. The RMI's comments are included below:

(a) Section 244(a) of the amended Compact provides that "All products of the United States imported into the Republic of the Marshall Islands shall receive treatment no less favorable than that accorded like products of any foreign country with respect to customs duties or charges of a similar nature and with respect to laws and regulations relating to importation, exportation, taxation, sale, distribution, storage or use." Needless to say, the above provision puts the RMI at a disadvantage in relation to negotiating Free Trade Agreements with other developed countries. In short, Section 244(a) states that if the RMI provides better treatment of imports of other developed countries that the status quo provided to the U.S. now, this treatment will automatically apply to the U.S. As a small island developing state, the RMI will lose twice: first to the other developed country, and second to the U.S. with respect to this "free rider" application. In order for the RMI to fully explore other developed countries markets and diversify its exports markets, a waiver by the U.S. Government is necessary. Providing RMI with this flexibility under the amended Compact will enable RMI to explore new markets and also develop its sectors, which necessitates the waiver of Section 244(a). This waiver is implicit in Section 244(c) of the amended Compact as follows: "Prior to entering into consultations on, or concluding, a free trade agreement with governments not listed in Article 26 of PICTA, the Republic of the Marshall Islands shall consult with the United States regarding whether or how subsection (a) of section 244 shall be applied."

(b) Despite the fact that U.S. has granted RMI duty free and quota free access for almost all products, i.e. zero import duties, it has not provided the RMI with duty free access on key products. Under the amended Compact, 0% tariff is provided for fresh, or frozen tuna and fresh or frozen tuna fillets. However, for canned tuna there is a duty of 6-12% for canned tuna in water and 35% for canned tuna in oil. Furthermore, the Rules of Origin (ROO) requirement for exporting into the U.S. is 35% out of which about 15% of the value of materials has to be from the U.S.

RMI requests that U.S. provides 0% duty on canned tuna both in water and in oil. This will enable RMI to develop its canneries and thus create more jobs and also attract foreign direct investment. This will also have value addition to RMI's fisheries products. In addition to this, RMI requests flexible rules of origin of 35% without any conditions on where we source the materials from, meaning that it can be from U.S. or any other country (the 15%). We note that under the

Generalized System of Preference, U.S. is already providing duty free access on these products to other countries. Given the special and unique relationship envisioned under the amended Compact, RMI needs the same.

38. Without prejudice as to future consideration of these two issues on a bilateral or multilateral basis, this report makes no recommendation for action on this request.

II. POLITICAL AND SOCIAL CONTEXT

39. The Republic of the Marshall Islands is a sovereign nation. While the government is free to conduct its own foreign relations, it does so under the terms of the Amended Compact. The United States and the Marshall Islands have full diplomatic relations. Marshallese citizens join the U.S. military at higher rates than many U.S. states and are eligible for admission to most U.S. Service Academies.

40. The Republic of the Marshall Islands remains a mixed parliamentary-presidential democracy. The constitution provides citizens the ability to choose their government in free and fair periodic elections based on universal and equal suffrage. The legislative branch of the government consists of the Nitijela with an advisory council of high chiefs. The Nitijela has 33 members from 24 districts elected for concurrent four-year terms. The Council of Iroij (traditional chiefs) oversees land ownership and adherence to custom.

41. According to State Department Human Rights Report and the International Religious Freedom Report, the constitution of the RMI provides for freedom of speech and expression, and the government of the RMI generally respects these rights. An independent press, an effective judiciary, and a functioning democratic political system combined to provide for freedom of speech and of expression. The government did not restrict or disrupt access to the internet or censor online content, and there were no reports that the government monitored private online communications without appropriate legal authority. Internet access and availability was increasing, although it remained low due to high cost and technical difficulties. There were no government restrictions on academic freedom or cultural events. The constitution provides for the freedoms of assembly and association, and the government respected these rights in practice.

42. The constitution of the RMI provides for freedom of association, and the government interpreted this right as allowing the existence of labor unions. The law neither provides for nor prohibits the right to strike, and there is no legislation concerning collective bargaining or trade union organization. There are no laws prohibiting anti-union discrimination or allowing for reinstatement of a person dismissed for union activity.

43. The RMI is party to UN Convention Against Corruption. Marshallese laws provide criminal penalties for official corruption, although a lack of investigative capacity and material resources have hindered the effective implementation of the law. The government reported that corruption was sometimes overlooked. The 2014 audit of the national government and its components, including state-owned enterprises, was due in September, but the country received an extension to November 30. The 2013 audit listed several deficiencies and material weaknesses.

44. These reports state that the constitution prohibits discrimination on the basis of sex, race, color, religion, language, national or social origin, political opinion, place of birth, and family status or descent, and the government generally observed these provisions.

45. The International Religious Freedom Report states that that religious freedom is protected by law and custom. Christianity remains the dominant religion. No laws or significant

government practices, however, impinge on other religious groups in the practice of their religion.

46. The RMI is not a party to the 2000 UN TIP Protocol. As noted in the State Department's 2016 Trafficking in Person's Report, the Government of the Republic of the Marshall Islands does not fully meet the minimum standards for the elimination of trafficking and is not making significant efforts to do so. The RMI remains on Tier 3 for the 2016 reporting period.

III. Review of Economic Conditions

A. Growth and Employment

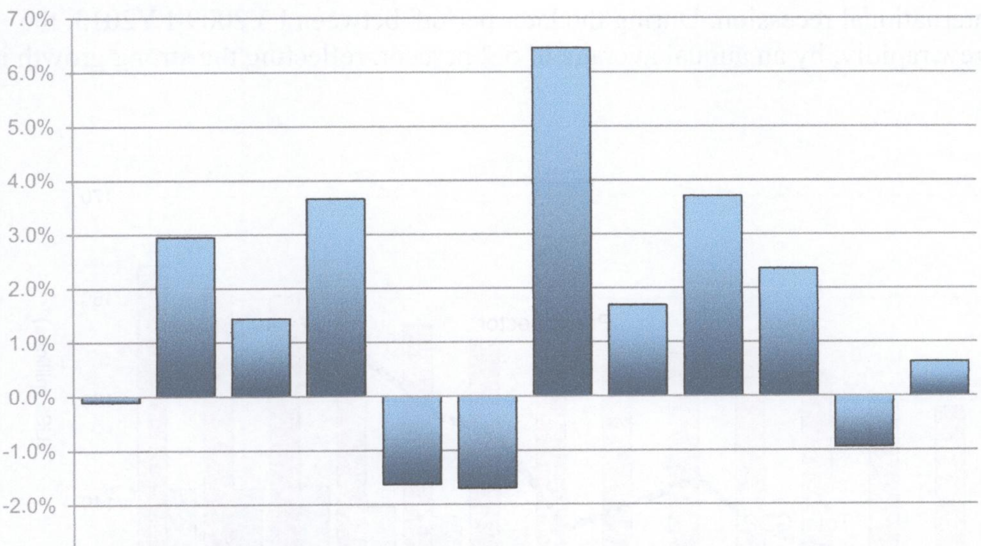
1. Developments in the RMI Economy

i Major trends in economic activity

47. Overall, the RMI economy as depicted in Figure 3.11 has performed well during the reporting period, given the remote, resource-scarce nature of the economy and the declining level of real Amended Compact sector grant assistance. Real GDP grew by an annual average of 1.8 percent per annum, with private and government growth of 2.4 percent and 2.1 percent, respectively[3]. Despite an increase in annual funding under the Amended Compact, the economy stagnated, primarily from the closure of the fish loining plant and capacity constraints in using additional fiscal resources (see Figure 3.1).

48. During FY2005 the RMI used the substantial increase in Amended Compact resources to expand the economy. The private sector maintained economic activity, with additional investment demand arising from increased Amended Compact infrastructure grants and spending on other public and private construction. Real GDP grew by 2.6 percent, 1.9 percent, and 3.8 percent in the three years from FY2005 to FY2007.

49. By FY2008 the economy had peaked, and real GDP fell by 2 percent. The initial wave of Amended Compact infrastructure construction projects had been completed, and further



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Real GDP	-0.1%	2.9%	1.4%	3.7%	-1.6%	-1.7%	6.4%	1.7%	3.7%	2.4%	-0.9%	0.6%

Figure 3.1 RMI real GDP growth (percent)

[3] Note the difference between GDP growth and private and government expansion is comprised of changes in other institutional sectors.

expansion in government was no longer possible, as expenditures hit their ceilings. FY2008 also saw the end of rapid expansion in the global economy, as fuel and food prices reached record levels. Inflation in the RMI climbed to 15 percent, eroding real incomes and reducing demand for local business. In FY2009, while inflation eased back to 0.7 percent and reduced the erosion in household incomes, the same general economic forces exerted themselves, and real GDP fell again by a further 1.7 percent.

50. In FY2010 the RMI economy grew by a surprising 6.1 percent given continuing weak international economic conditions. The main driving force was expansion in the fisheries sector, which contributed half of the overall growth, with increased output from the reopened loining plant and the addition of new purse seiners to the fishing fleet. Economic performance in FY2011 was lackluster, but both FY2012 and FY2013 were strong, recording a rate of growth of 4.7 percent and 3 percent in each of the two years, respectively. The fisheries industry was an important contributor to this growth, with the output of domestic purse seiners increasing in FY2012 and an increase in loining plant output in FY2013. Construction activity fell in FY2012, reflecting the imposition of a moratorium on Amended Compact-funded infrastructure projects. In FY2013, despite continuing issues with implementation of other infrastructure projects, the completion of the Federal Aviation Administration airport road realignment project had a positive impact.

ii Developments in the private, government, and SOE sectors

51. Figure 3.2 elaborates on the story, indicating the performance and contribution of the private and government sectors to the economy. Private sector performance was weak during the first six years of the Amended Compact (FY2004-FY2009), after the closure of the fish loining plant and international recession. During the later period, between FY2009-FY2013, the economy grew rapidly, by an annual average of 5.2 percent, reflecting the strong growth in

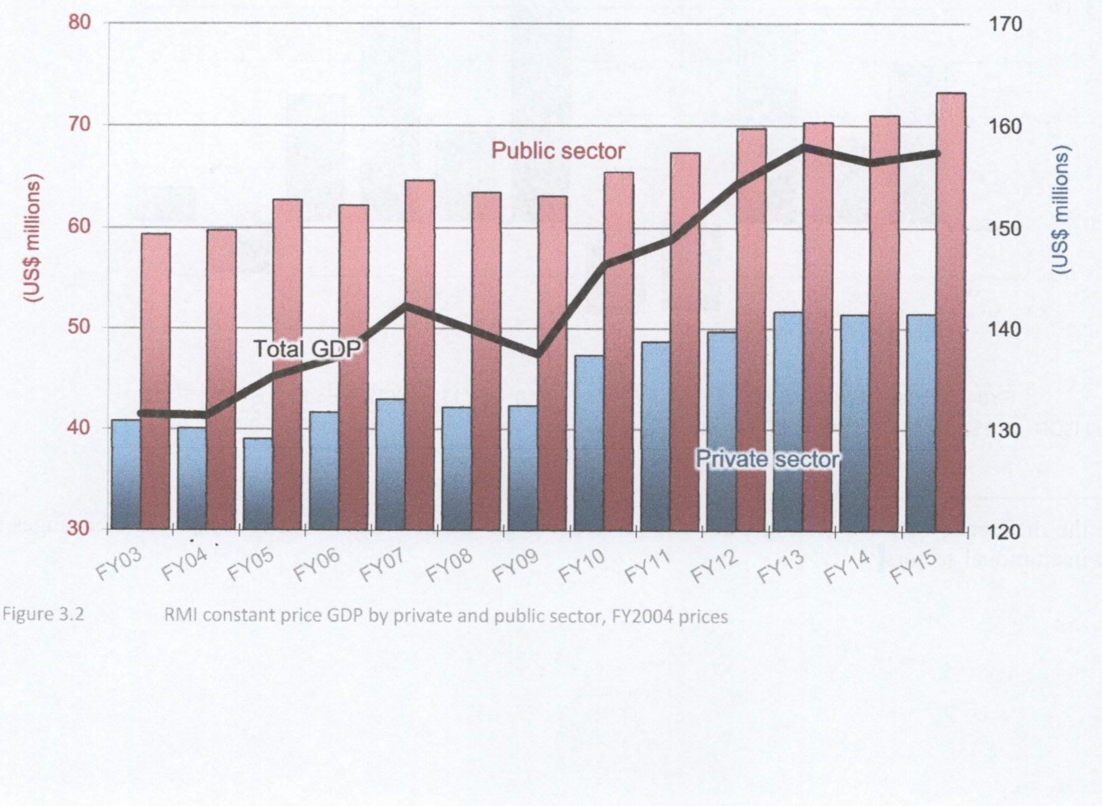


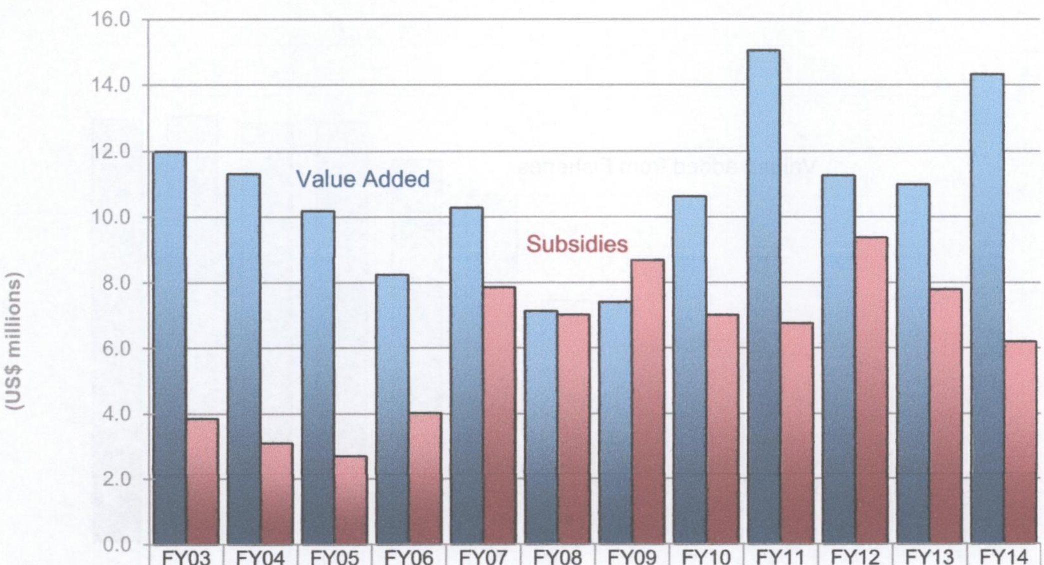
Figure 3.2 RMI constant price GDP by private and public sector, FY2004 prices

fisheries.

52. The general government sector in the RMI is comprised of the central government (68 percent), the local governments of Majuro Atoll and Kwajalein Atoll (14 percent), and agencies (17 percent), including the College of the Marshall Islands (CMI). Taking government as a whole, there have been three phases: a first phase, depicting expansion, when growth averaged 3 percent per annum, reflecting increases in the RMI government from FY2004-FY2007; a second period, showing decline, from FY2007-FY2009, which coincided with the international financial crisis, as all elements of government contracted; and a third, more recent expansionary phase since FY2009, resulting from growth in the CMI. Of the total growth of 19 percent during the Amended Compact, the private sector was responsible for 8.2 percent and government for 8.1 percent. Thus, while government remains the major driver in the economy, the smaller and dependent private sector has performed well.

53. The state-owned enterprise (SOE) sector is particularly significant in the RMI because of its large and frequently negative impact on GDP growth. Figure 3.3 provides a snapshot of trends in value added and subsidies over the reporting period. The contribution of the SOE sector to the economy began to deteriorate in FY2003. Production continued to fall and reached a low in FY2008, primarily from poor performance in the energy sector. The situation has subsequently improved, largely as a result of regularizing the financial situation with the Marshalls Energy Company (MEC). However, during the reporting period, the contribution of the SOE sector has remained largely unchanged, despite the growth in the economy.

54. With the deterioration in the financial viability of many SOEs, the demand for government subsidies increased. From FY2003 to FY2006 the annual average level of government subsidies was $3.4 million. However, the level of subsidization jumped to a new high, averaging $7.6 million per annum between FY2007 and FY2013. This jump was due to a variety of forces but was heavily influenced by the impact of high energy prices on the financial



	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Value added	12.0	11.3	10.2	8.2	10.3	7.1	7.4	10.6	15.1	11.3	11.0	14.3
Subsidies	3.8	3.1	2.7	4.0	7.9	7.0	8.7	7.0	6.8	9.4	7.8	6.2

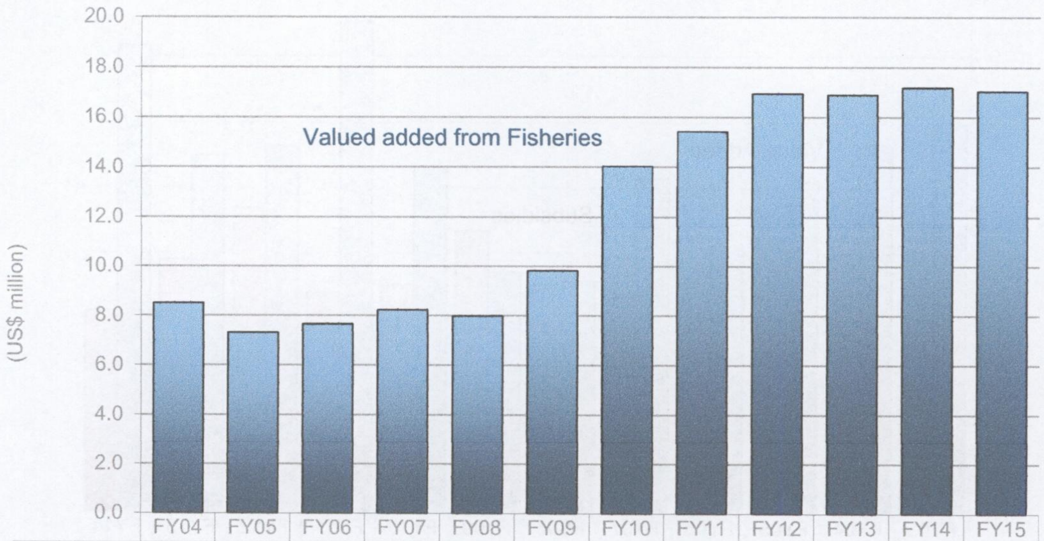
Figure 3.3 Public enterprises value added and subsidies, current prices
Note: Value added is measured at current producer prices before subsidies

position of the MEC and the Kwajalein Atoll Joint Utility Resources (KAJUR).

iii Fisheries and other industry developments

55. The fisheries sector has been a strong driver of growth, commensurate with the economy's comparative advantage. However, growth has been erratic, reflecting the opening and closure of the Philippines Micronesia and Orient Line Processing Plant (PMOP) in FY2003 and replacement with the Pan Pacific Foods (PPF) operation in FY2008. The PPF fish loining plant operates at a loss, which is offset through access to RMI fishing rights. The impact of the recent developments, primarily with the reopening of the loining plant and the operation of new purse seiners by PPF, has been a dramatic rise in the contribution of commercial fisheries to the economy (see Figure 3.4). Value added has risen from an average level of $7.2 million in FY2005 to $18.2 million in FY2013 (constant prices FY2004). This represents an impressive increase from 6.3 percent of GDP in FY2005 to 16.8 percent of GDP in FY2013.

56. Figure 3.5 summarizes and indicates the major drivers of the RMI economy during the Amended Compact period. The economy grew by a total of 19.6 percent. The combined activities of public administration, education, and health were responsible for 8.2 percent of this total, much of it in the early part of the Amended Compact. The fisheries sector has been a strong driver, responsible for more than any other sector, representing 6.7 percent or about a third of the total growth. However, while the impact of the loining plant has been significant, the impact of purse seiner operations on the domestic economy is minor, given that there is little employment of Marshallese, profits are returns on foreign investment, and operational costs are largely purchased offshore. Construction activity has not played a major role in economic performance trends, despite the emphasis of the Amended Compact sector grants on infrastructure. Other private sector activities have remained largely unchanged, but of special note is the negative contribution of hotels and restaurants, considered to be one of the RMI's sectors of comparative advantage. Finance has made a minor but still significant contribution, reflecting the proactive



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Value added	8.5	7.3	7.7	8.2	8.0	9.8	14.0	15.4	16.9	16.9	17.2	17.0

Figure 3.4 Commercial fisheries contribution to GDP, constant prices FY2004

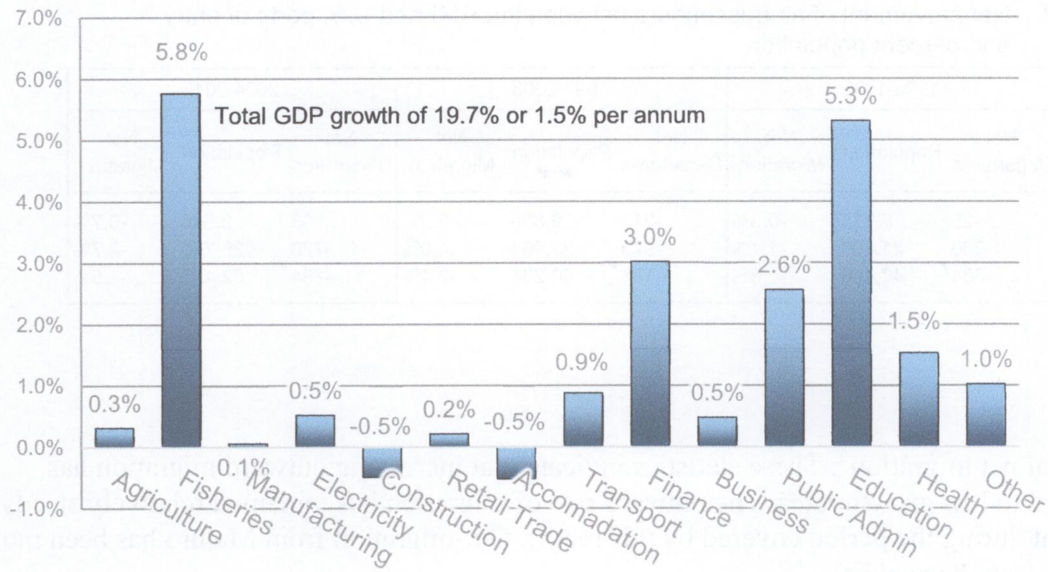


Figure 3.5 Contribution to GDP growth by industry between FY2003 and FY2015 (percent)

stance of the local bank.

2. Demographics, Incomes, and Income Dispersion

i Population

57. The results of the 2011 population census indicated that overall population growth slowed to 0.4 percent, continuing a trend witness after the original Compact entered into force. Declining population growth appears to be a consequence of a reduction in fertility rates and the emergence of large out-migration to neighboring U.S. territories, Hawaii, and the U.S. mainland under the immigration provisions of the Compact. Growth in Majuro's population also slowed, while in Ebeye growth was largely static, and figures from the outer atolls indicate the emergence of depopulation. While overall population growth has been moderated by out-migration, inward migration from Asia has been significant.

ii Migration

58. Table 3.2 provides further information on current migration rates and net movement of passengers between the RMI and various U.S. destinations. Since the destination of nearly all flights originating within the RMI is a U.S. point of entry, the figures provide a very useful

Table 3.1 Population by major centers and population growth, 1988-2011

	Population				Population Growth			
	Total	Majuro	Ebeye	Other	Total	Majuro	Ebeye	Other
1988	43,380	19,664	8,324	15,392	4.3%	6.6%	3.8%	2.2%
1999	50,840	23,676	9,345	17,819	1.5%	1.7%	1.1%	1.3%
2010	53,158	27,797	9,614	15,747	0.4%	1.5%	0.3%	-1.1%

Source: Census reports

Table 3.2 Net movement of air passengers between the RMI and U.S. ports of entry and percent population

	1990-1996			1997-2003			2004-2012		
	Net Departures	Population	Net Migration	Net Departures	Population	Net Migration	Net Departures	Population	Net Migration
Kwajalein	-25	8,775	-0.3%	-211	9,335	-2.3%	-65	9,546	-0.7%
Majuro	-360	21,408	-1.7%	-970	23,969	-4.0%	-729	26,720	-2.7%
RMI	-384	46,448	-0.8%	-1,181	50,234	-2.4%	-794	52,123	-1.5%

Source: U.S. Department of Transportation "TRANSTATS" database
Notes: Population estimates based on average projected levels between census points.
Only includes air passengers to/from the RMI and U.S. airports (Guam, Hawaii, Saipan).
Passengers to/from the RMI and other countries (e.g., FSM) are excluded.

indicator of net migration[4]. These statistics indicate that increasing outward migration has contributed to low growth rates. The outward rate of migration has remained relatively steady at 1.5 percent during the period covered by this report. Out-migration from Majuro has been more rapid than from Kwajalein.

iii Income levels

59. Figure 3.6 shows changes in real constant-price GDP per capita and provides a picture of the developments in average real incomes. Between FY2003 and FY2015, GDP per capita expanded by $288, an average rate of 0.9 percent in each year, but it failed to regain the level achieved in the mid-1990s. In FY2008 and FY2009, GDP per capita faltered and took a downward turn, as the economy felt the negative impact of the international financial recession.

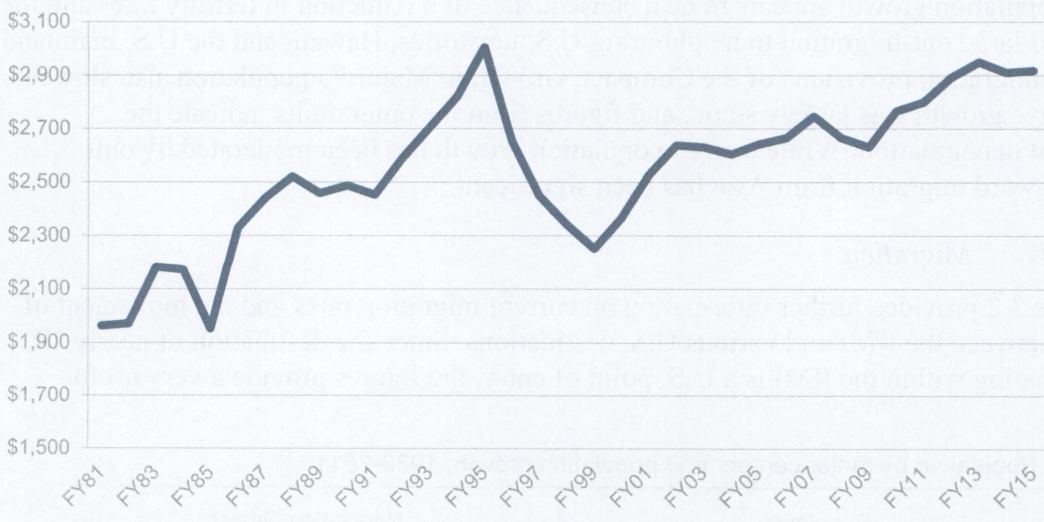


Figure 3.6 GDP per capita, FY1981-FY2015, constant prices 2000 (US$)

4 The quality of the data deteriorated in FY2011 due to changes in data recording methods, indicating an untenable reverse flow. FY2012 data has been excluded from Table 3.2.

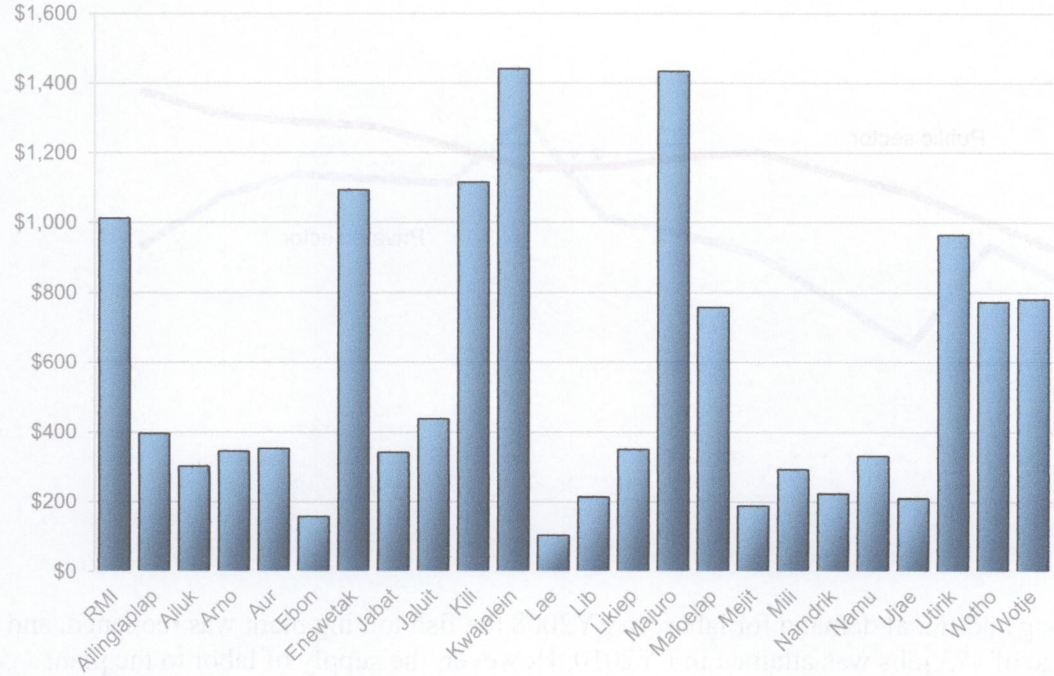


Figure 3.7 Average household income by island, 2011 prices (US$)
Source: 2011 census

However, by FY2015 GDP per capita had regained the lost ground, nearly reaching the level attained 18 years prior.

iv Income Disparity

60. The nature of the RMI, with two major population centers and a large number of outer atolls, results in significant income disparity. According to 2011 census data, 41 percent of outer-islanders have an income of less than $1 a day (in 2011 prices). Figure 3.7 provides an overview of average per-capita cash income in the various atolls of the RMI. Economic activity clearly differs between the urban centers of Majuro and Kwajalein—comprising the bulk of the nation's cash economy and labor market—and the outer atolls. Cash incomes in Majuro and Kwajalein are three times those of the outer atolls. However, within the outer atolls, the cash incomes of the nuclear-affected communities of Enewetak and Kili are substantially above those of the other islands. In the non-nuclear-affected islands, average per-capita incomes range from $104 a year on Lae to $758 on Maloelap. Clearly, the lack of income-earning opportunities has provided a strong incentive to migrate to the two major urban atolls and to the U.S. and her territories.

3. Employment, Earnings, and Wages

a) Employment

61. At the start of the Amended Compact, increased demand in the economy led to growth in private sector employment (see Figure 3.8). However, in FY2005 employment fell by 14 percent (572 employees), with the closure of the fish loining plant, to a level of 3,655. In the subsequent period from FY2005-FY2010, private sector employment began to expand again, despite the negative impact of the global financial crisis. In FY2006 and FY2007 construction activity

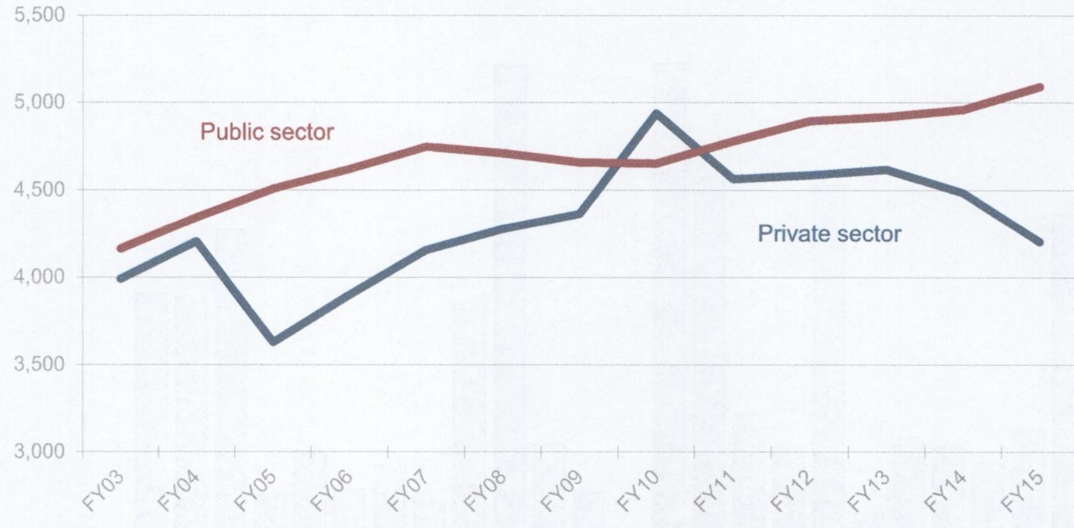


Figure 3.8 Employment in the private and public sectors

created strong additional demand for labor. In FY2008 the fish loining plant was reopened, and a daily average of 473 jobs was attained in FY2010. However, the supply of labor to the plant contracted between FY2011 and FY2013, and the daily average fell to 250 laborers. The labor shortages at the plant and falling construction demand led to a reduction in private sector employment in FY2011, and levels had failed to recover by 2013.

62. Public sector employment expanded strongly in the early stages of the Amended Compact and peaked in FY2007. Public sector employment (including public enterprises, agencies, as well as local and central government) grew by 14 percent between FY2003 and FY2007, at an annual average rate of 3.4 percent. Between FY2007 and FY2010, public sector employment contracted under tight fiscal conditions but showed signs of growth between FY2010 and FY2013, as conditions eased. The majority of the jobs created have been in education, both through the provision of government services and through the CMI.

63. Figure 3.9 shows the overall rate of job creation ng the Amended Compact from all institutional sectors, including the U.S. Army Garrison Kwajalein Atoll (USAG-KA). In FY2008 and FY2009, restructuring of operations at USAG-KA and declines in construction output offset the reopening of the loining plant, and employment fell by 0.4 in both years, respectively. However, in FY2010 significant growth in employment at the loining plant compensated for the declines in the prior two years, despite continuing layoffs at USAG-KA and reductions in construction. Overall, employment growth expanded by 5.1 percent. In FY2011 employment contracted, due to labor shortages at the loining plant, and was largely stagnant in the following two years (FY2012-FY2013).

i *Wages*

64. Figure 3.10 illustrates trends in real and nominal wage rates. First, private and public sector wages have grown during the period by 1.7 percent and 1.4 percent, respectively. However, real wages have fallen by 2.3 percent and 2.6 percent, respectively. The difference between the nominal and real wages is 4 percent and reflects the average rate of inflation during

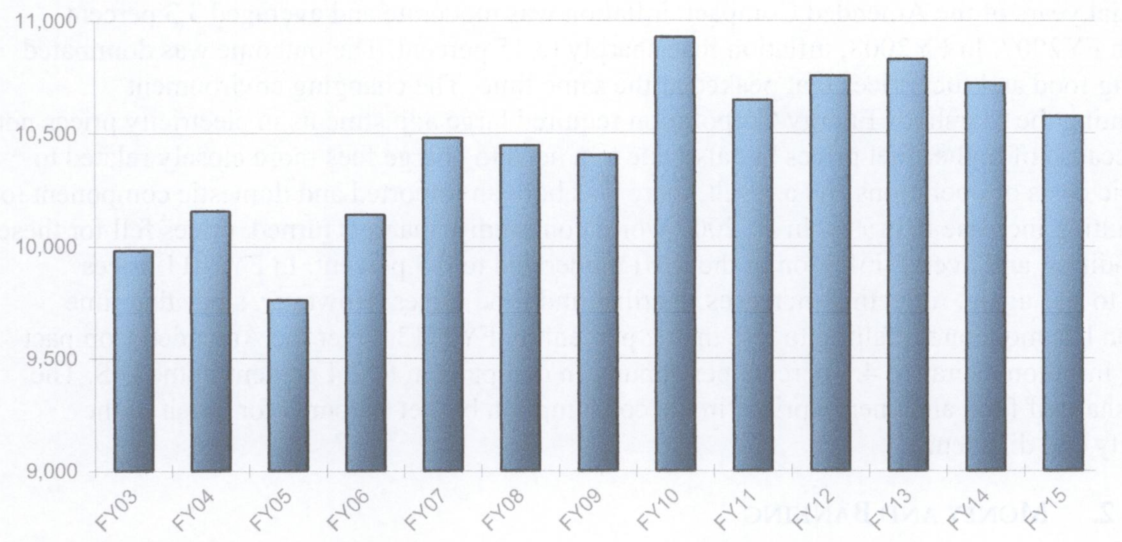


Figure 3.9 Total employment in the RMI economy

this period. Figure 3.10 shows that average public sector wages are significantly higher than those in the private sector. However, it would be incorrect to conclude that public sector wage rates for similar skills are higher than in the private sector, as no data exists to support this. The data indicates that the wage differential has narrowed during the period, from 248 percent in FY2003 to 217 percent in FY2013, and while small, it is a move in the right direction.

B. *Monetary Developments and Prices*

1. Prices

65. Figure 3.11 indicates changes in the CPI during the Amended Compact period. During

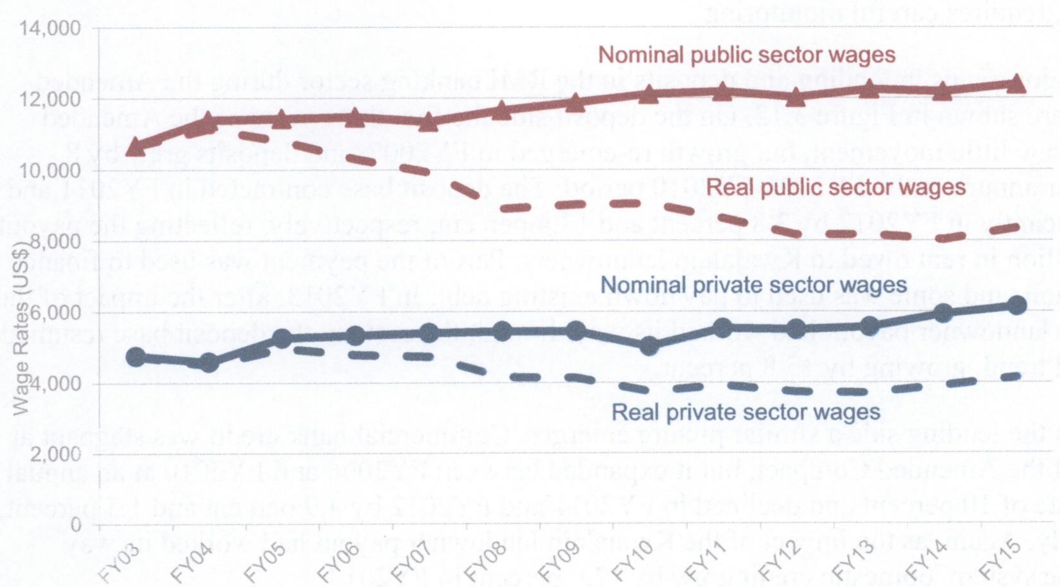


Figure 3.10 Nominal and real wage rates by major institutional sector

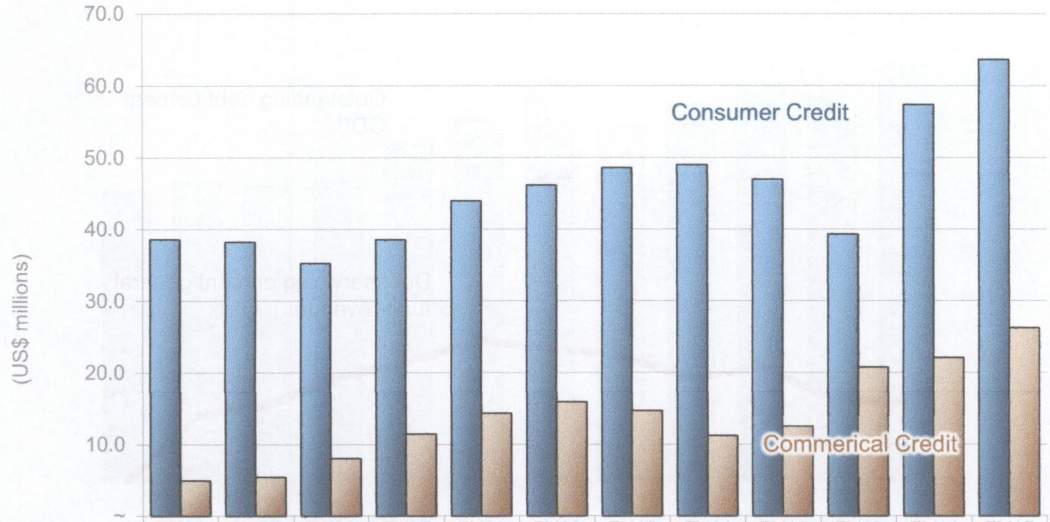
the initial years of the Amended Compact, inflation was moderate and averaged 3.3 percent through FY2007. In FY2008, inflation rose sharply to 15 percent. The outcome was dominated by rising food and fuel prices that peaked at the same time. The changing environment confronting the Marshalls Energy Corporation required large adjustments in electricity prices not only because of higher fuel prices but also due to a need to charge fees more closely related to the basic costs of operations. As a result, there was both an imported and domestic component to the resulting increase in prices. In FY2009 world commodity markets turned, prices fell for these commodities, and overall inflation in the RMI moderated to 0.5 percent. In FY2011 prices started to rise again, reflecting increases in utility and food prices. However, since that time inflation has moderated, falling to less than 2 percent by FY2013. Over the Amended Compact period, inflation averaged 4.1 percent per annum, in comparison to 2.4 percent in the U.S. The larger share of food and energy prices in the consumption basket accounts for much of the volatility and difference.

2. Money and Banking

66. With the U.S. dollar as the official currency in the RMI, the RMI Government's macroeconomic policy and adjustment has been limited to the use of fiscal policy. As a result, domestic interest rates are closely aligned with those of the United States. Deposit interest rates observed in the market are broadly similar to those throughout the United States, while lending rates are generally higher, reflecting the additional risk and costs of doing business in the RMI. The banking system in the RMI is regulated by a banking commissioner, whose role includes the licensing of domestic and foreign banks, on- and off-site supervision of all commercial banks, and consumer protection. The Marshall Islands Development Bank (MIDB) does not currently come under the regulatory inspection of the banking commissioner. There is one locally owned bank, the Bank of the Marshall Islands, and one U.S. bank, the Bank of Guam, which is a branch of its parent registered in the United States, and comes under U.S. federal supervisory requirements. Although the financial system has provided satisfactory and secure banking services, the marketplace, because of its small size and lack of a well-developed supervisory capability, requires careful monitoring.

67. Major trends in lending and deposits in the RMI banking sector during the Amended Compact are shown in Figure 3.12. On the deposit side the first three years of the Amended Compact saw little movement, but growth re-emerged in FY2007, and deposits grew by 8 percent per annum in the FY2006-FY2010 period. The deposit base contracted in FY2011 and fell significantly in FY2012 by 3.8 percent and 13.4 percent, respectively, reflecting the payout of $29 million in rent owed to Kwajalein landowners. Part of the payment was used to finance consumption, and some was used to pay down existing debt. In FY2013, after the impact of the Kwajalein landowner payout had worked its way through the system, the deposit base resumed its upward trend, growing by 15.8 percent.

68. On the lending side a similar picture emerges. Commercial bank credit was stagnant at the start of the Amended Compact, but it expanded between FY2006 and FY2010 at an annual average rate of 10 percent and declined in FY2011 and FY2012 by 4.9 percent and 1.3 percent, respectively. Again, as the impact of the Kwajalein landowner payout had worked its way through the system, domestic credit grew by 12.6 percent in FY2013.



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Consumer	38.5	38.2	35.2	38.5	43.9	46.1	48.6	49.0	46.9	39.2	57.4	63.7
Commercial	4.9	5.4	8.0	11.4	14.3	15.9	14.7	11.2	12.5	20.8	22.1	26.2

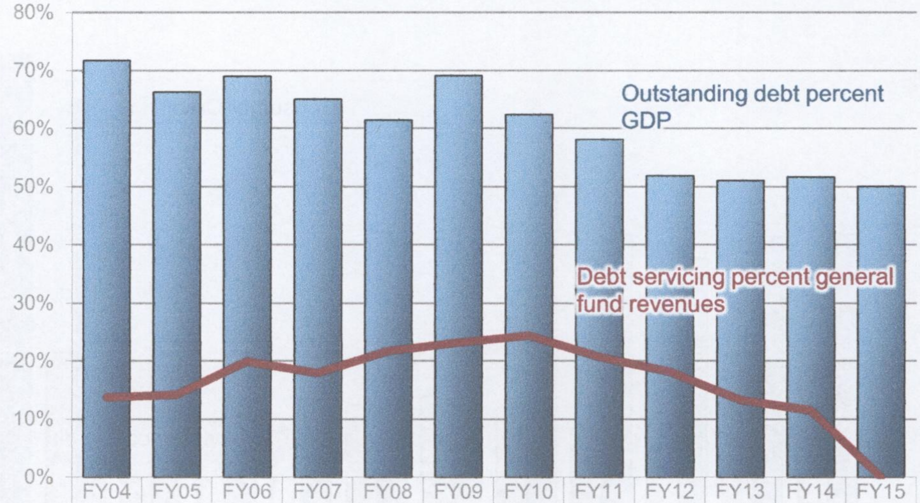
Figure 3.13 Commercial bank credit by sector

69. Figure 3.13 indicates the extension of credit to the private sector in the consumer and commercial markets during the Amended Compact period. At the start of the period, lending opportunities for consumer credit declined. However, they generated an upward trend from FY2006, growing by an annual average of 6.8 percent through FY2011 and dropping back by 4.3 percent in FY2012, as landowners repaid debt. Consumer lending resumed its upward trend in FY2013, growing by 1.7 percent. The figures reflect a high level of household debt, which is estimated to be 49 percent of gross wages, before the deduction of contributions for social security and health insurance. This not only places stress on household finances but could pose a threat to the banking system.

70. While growth in consumer credit has been buoyant during much of the Amended Compact, lending to the commercial sector has been weak and reflects insufficient collateral, poor business management, and the many impediments to lending. At the start of the Amended Compact, lending to the commercial sector stood at $4.9 million. This rose through FY2009 to $15.9 million, but in FY2010 and FY2011 commercial credit eased back, which, in the later year, reflects pay down of debt out of the Kwajalein landowner settlement. In FY2012 commercial lending recovered and in FY2013 bounced back strongly, adding $8.3 million in credit over the two years. In FY2013 the level of commercial credit represented 11.5 percent of monetary GDP, which, despite recent improvements, indicates a low level of financial intermediation.

C. *External Debt*

71. RMI has substantial external debts involving a sizable debt servicing burden and including government guaranteed debt to the SOE sector that have significant implications for RMI's fiscal policy, and could have fiscal consequences should an SOE default. In total, the ADB has approved $91.1 million worth of loans since the RMI joined in 1991, and all but $4 million of this outstanding amount is provided on highly concessional terms from the Asian Development Fund (ADF). Other major external debt commitments represent government



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Outstanding	72%	66%	69%	65%	61%	69%	62%	58%	52%	51%	52%	50%
Servicing	14%	14%	20%	18%	22%	23%	24%	21%	18%	13%	11%	0%

Figure 3.14 RMI external debt (percent GDP) and debt servicing (percent general fund revenues), FY04-FY15

guaranteed debt to the SOE sector and liabilities owed to the U.S. Department of Agriculture (USDA) Rural Utilities Service (RUS) for loans to the National Telecommunications Authority (NTA) and the MEC. In 2009 the NTA again extended the RUS facility by a further $14.5 million to finance the fiber-optic link from Kwajalein to Majuro. In all cases of default by the SOEs, the RMI must meet debt service requirements. With $97.6 million in FY2013 of external debt still outstanding in loans, this could have significant fiscal consequences for the RMI government if any of the SOEs default.

72. Figure 3.14 shows the substantial size of the RMI's external debt and the burden of the debt servicing from FY2004 to FY2013. In FY2003 the level of outstanding debt was $94 million (72 percent of GDP). External debt had risen to $98 million by FY2013, but as a percent of GDP, it had declined to 62 percent. Debt service increased from $3.9 million to $6.3 million, or from 11 percent to 15 percent of general fund revenues[5]. The RMI debt profile as a percent of GDP has improved significantly during the Amended Compact, resulting from restraint on new borrowing and growth in nominal GDP. However, the external debt service picture is different. While much of the RMI's debt is on concessional terms, there has been a substantial increase in debt service, as grace periods of prior loans have expired. Since external debt servicing is funded out of the government's discretionary resources, there are significant implications for the RMI's fiscal policy.

5 The sharp rise in debt service in FY2007 and again in FY2011 represents transactions relating to the MEC; original debt owed to Mobile was refinanced through a loan from the Bank of Guam, which was subsequently refinanced through a concessional loan from the ADB.

D. Fiscal Developments

1. Fiscal Policy Framework

73. The Amended Compact's entry into force initiated a new fiscal framework for the RMI. The new structure entailed a series of sector grants earmarked for specific areas: education, health, private sector development, public sector capacity building, public infrastructure, and the environment. In addition to the sector grants, the Amended Compact provides annual grants for Ebeye special community needs and environmental impact, audit, and Kwajalein landowners. The Amended Compact also established a Trust Fund for the people of the RMI (CTF), which was designed to provide an additional source of revenue after FY2023 to be used in the specific sectors described above. Table 3.3 indicates the aggregate structure of the annual Amended Compact grants and the contributions to the CTF. Each year as detailed in section 217 of the Amended Compact, the United States contributes $57.7 million to the RMI, partially adjusted (2/3) for inflation. The annual sector grants started at $31.9 million in FY2004 but are to be annually reduced by $0.5 million, which will be deposited into the CTF to accumulate until FY2023 when direct sector grant assistance terminates. The United States agreed to contribute an additional $5 million annually to the RMI in FY2014-FY2023, $2 million of which would be added to the Ebeye special community grants; the remaining $3 million would be allocated to land use payments for the Kwajalein landowners.

74. The Compact Agreement requires RMI use no less than 30 percent and no more than 50 percent of the total Amended Compact annual grant assistance provided under section 211 for public infrastructure. Of the infrastructure grant, 5 percent must be set aside for infrastructure maintenance, and the RMI must contribute a matching 5 percent out of non-Compact revenues. In general, the implementation of the sector grant approach of the Amended Compact did not impose on the RMI any effective fiscal constraints or the need for restructuring. At the outset

Table 3.3 U.S. annual Compact grants and contributions to the Trust Fund (US$ millions)

	Annual Sector Grants	Ebeye Special Community Needs	Ebeye Environmental Impact	Audit	Kwajalein Impact (Landowners)	Trust Fund Contribution	Total Contributon	Ebeye Community Landowners
FY04	31.9	3.1	0.2	0.5	15.0	7.0	57.7	1.9
FY05	31.4	3.1	0.2	0.5	15.0	7.5	57.7	1.9
FY06	30.9	3.1	0.2	0.5	15.0	8.0	57.7	1.9
FY07	30.4	3.1	0.2	0.5	15.0	8.5	57.7	1.9
FY08	29.9	3.1	0.2	0.5	15.0	9.0	57.7	1.9
FY09	29.4	3.1	0.2	0.5	15.0	9.5	57.7	1.9
FY10	28.9	3.1	0.2	0.5	15.0	10.0	57.7	1.9
FY11	28.4	3.1	0.2	0.5	15.0	10.5	57.7	1.9
FY12	27.9	3.1	0.2	0.5	15.0	11.0	57.7	1.9
FY13	27.4	3.1	0.2	0.5	15.0	11.5	57.7	1.9
FY14	26.9	5.1	0.2	0.5	18.0	12.0	62.7	1.9
FY15	26.4	5.1	0.2	0.5	18.0	12.5	62.7	1.9
FY16	25.9	5.1	0.2	0.5	18.0	13.0	62.7	1.9
FY17	25.4	5.1	0.2	0.5	18.0	13.5	62.7	1.9
FY18	24.9	5.1	0.2	0.5	18.0	14.0	62.7	1.9
FY19	24.4	5.1	0.2	0.5	18.0	14.5	62.7	1.9
FY20	23.9	5.1	0.2	0.5	18.0	15.0	62.7	1.9
FY21	23.4	5.1	0.2	0.5	18.0	15.5	62.7	1.9
FY22	22.9	5.1	0.2	0.5	18.0	16.0	62.7	1.9
FY23	22.4	5.1	0.2	0.5	18.0	16.5	62.7	1.9

there were sufficient general fund revenues to maintain operations without reducing expenditures in non-Compact sectors. From FY2004 to FY2013, the use of sector grants for private sector development, public sector capacity building, and the environment was minimal.

75. In addition to the annual sector grants, contributions to Kwajalein landowners, and CTF, the Amended Compact provided $1.9 million (see Table 3.3, last column) to address the special needs of the Ebeye community, with emphasis on the Kwajalein landowners. Access to federal programs continues, with the exception of certain education programs, which were replaced by the Supplemental Education Grant (SEG). The Amended Compact specified an initial SEG award of $6.1 million, to be adjusted for inflation. However, since this award is subject to annual appropriations, no adjustment has been applied.

76. In contrast with the original Compact, the new arrangement avoids the need for large fiscal adjustments every five years because of the annual decrement. While avoiding large shocks to the system, the annual decrement still requires adjustments. Coupled with the two-thirds inflation adjustment, the annual reduction in real resources—estimated to be approximately 2 percent—will require active fiscal policy adjustments, unless the RMI develops a policy regime that will attract and encourage private sector investment and sustainable economic growth sufficient to offset the decline in resources from Amended Compact sector grants.

77. The annual budget allocations are determined through the JEMFAC. Per the terms of the FPA, incorporated by reference into the Amended Compact legislation, the U.S. has three members and the RMI has two. Each year the RMI presents its annual sector grant submissions to the U.S. in advance of the JEMFAC annual meeting, which is convened in late August to make the annual budget allocations before the new fiscal year starts October 1. Finally, the implementation of the Amended Compact entailed new fiscal accountability requirements that are specified in the FPA. The Amended Compact has had an important impact on the conduct of fiscal policy and management in the RMI.

78. In addition to the special relationship the RMI enjoys with the United States, the RMI has also developed strong ties with Taiwan. Initially, Taiwan contributed $10 million annually to the RMI government, of which $4 million was transferred to the general fund, and the remaining $6 million was available for special projects, to be mutually agreed upon. As fiscal pressures have mounted, more of the project money has been used for general activities, and, in effect, the project contribution augments general fund revenues. Of special significance is the additional support provided by Taiwan to the CTF. Under a memorandum of understanding (MOU), Taiwan has agreed to transfer $40 million to the RMI during the period of the Amended Compact.

79. Fiscal policy in the RMI is conducted under the constitutional requirement of a "balanced budget." This does not guarantee that the final outcome will also be balanced: either revenue may fall short, or expenditures may exceed budget estimates. The execution of the budget operations is performed through a series of separate funds, the most important of which is the general fund. Expenditures from the general fund are largely unrestricted, but there is limited flexibility or authority to use monies from the other funds. Fiscal policy in the macroeconomic sense is executed only through the general fund. The structure of the standard Government

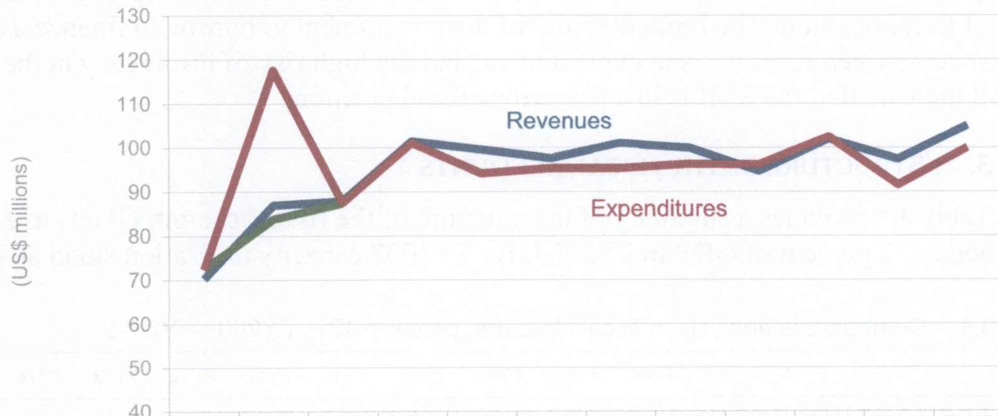
Finance Statistics (GFS), which aggregates across funds and focuses on "above-the-line" revenues and expenditures and "below-the-line" financing, does not always highlight some of the additional constraints faced by fiscal policy makers and finance officials in the RMI. Even when the GFS treatment shows an annual fiscal surplus, it is not uncommon for there to be constraints or rigidities that result in the appearance of fiscal distress. The most common of such constraints or rigidities is a lack of short-term liquidity through the general fund to meet current obligations.

80. Government in the RMI consists of the national government, the urban local governments of Majuro Atoll Local Government (MALGOV) and Kwajalein Atoll Local Government (KALGOV), the local governments of the nuclear-affected atolls (Bikini, Rongelap, Enewetak and Utrik), and other smaller atoll local governments. At present, local governments provide services such as administration, police, and garbage collection. Under the constitution, the power to raise taxes rest with the national government, but local governments may raise taxes, provided the increase has been authorized by law. The Local Government Act of 1989 provides the framework and limits the powers of local governments to levy taxes in specified areas—notably, sales taxes, licenses, and other indirect taxes.

81. The RMI had a satisfactory record of timeliness in the preparation and publication of the annual single audits by June 30th of the subsequent year for most of the period under review. However, the FY2011 audit was delayed until early 2013, the FY2012 audit was one month late, and for the FY2013 audit, the government was granted a three-month extension, due to changes in estimation of depreciation in a component unit (the NTA).

2. Recent Fiscal Performance

82. Fiscal developments during the Amended Compact may be divided into three periods: the early years of implementation, from FY2004-FY2007; the period during the financial crisis of FY2008-FY2009; and subsequent developments. Figure 3.15 represents recent trends in the RMI's fiscal position. It indicates that expenditures grew strongly in the first three years of the Amended Compact, with the availability of higher levels of funding. Initial capacity utilization



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Total rev	70	87	88	102	100	98	101	100	95	102	97	105
Exp adj for CTF	72	84	87									
Total exp	72	118	88	101	94	95	95	96	96	103	92	100

Figure 3.15 RMI consolidated revenues and expenditures, FY2004-FY2015

issues in the first two years of the Amended Compact with the infrastructure grant were overcome by FY2006, allowing further expansion. While a deficit of 1.6 percent of GDP was recorded for the first year of the Amended Compact, surpluses were attained from FY2005 to FY2007 (adjusting for the need to contribute $33 million to the CTF in FY2005).

83. By FY2008, the period of fiscal expansion, driven by the release and capacity to utilize new funding, had ended, and a fiscal correction was required. Revenue collection efforts were weak as the economy contracted with the onset of the global financial crisis and high levels of inflation. Tax revenues contracted by 2.3 percent. Total expenditures fell, reflecting expenditure compression and a significant drop in infrastructure spending. In FY2009 similar economic forces asserted themselves, the economy contracted, tax revenues fell, and a further reduction in expenditures was required. Despite the weak circumstances prevailing in both FY2008 and FY2009, a small fiscal surplus was achieved.

84. In the FY2010-FY2013 period, the economy improved, and tax revenues grew by 10 percent, although that was below the rate of nominal GDP growth of 17 percent, reflecting a weak and inefficient tax system. Government expenditures grew by 18 percent during this period, with the wage bill and use of goods and services growing by 9 percent and 16 percent, respectively. The major item generating the large increase in expense was the persistent growth in subsidies to the SOE sector. The major source of funding in the fiscal account during this period was the rapid rise in fishing fee royalties, which increased from $2 million in FY2010 to $7.9 million in FY2013. As a result, the Government's fiscal position remained in surplus, although it fell from a level of $6.4 million in FY2010 to $2.4 million in FY2013.

85. The close proximity of revenues and expenditures and the ability to maintain a fiscal surplus averaging 1.1 percent of GDP during the reporting period (excluding FY2005) provides a misleading impression of the fiscal situation in the RMI. The emerging crisis in FY2008, with the onset of the world recession and higher fuel prices, precipitated a financial crisis at the MEC—which, in turn, threatened the fiscal stability of the RMI. The existence of a priority list of creditors, difficulties in maintaining debt service obligations to the ADB, increasing use of the Taiwan project grant to fund operational expenditures, and daily cash flow problems all indicate a stressed fiscal position. The limited ability of the government to borrow to finance a deficit, the fine balance between revenues and expenditures, and the high risk of insolvency in the SOE sector all indicate that the RMI is in a precarious fiscal position.

3. STRUCTURE OF THE FISCAL ACCOUNTS

86. Table 3.4 provides a summary of the structure of the fiscal account. Grants as a percent of GDP stood at 33 percent of GDP in FY2004. By FY2007 capacity utilization stood at 108

Table 3.4 Comparative analysis of fiscal structure, percent GDP, FY2004-FY2015

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Grants	33.4%	41.1%	40.5%	46.4%	44.4%	44.4%	43.2%	40.1%	35.4%	34.5%	30.3%	31.8%
Grants as % Revenues	62.3%	65.0%	66.1%	68.5%	68.0%	68.5%	67.5%	65.5%	62.5%	60.1%	55.2%	53.7%
Tax Revenue	17.5%	18.3%	18.2%	19.2%	18.4%	18.3%	17.9%	17.8%	17.5%	17.1%	16.4%	17.4%
Total Expenditure	55.2%	85.5%	61.0%	67.4%	61.7%	63.3%	60.4%	59.1%	57.6%	57.8%	51.6%	56.4%
Current Balance	3.2%	-13.9%	10.6%	13.1%	12.6%	12.3%	14.0%	10.3%	3.5%	3.8%	6.4%	7.0%
Overall Balance	-1.6%	-22.3%	0.2%	0.3%	3.5%	1.5%	3.6%	2.3%	-0.8%	-0.2%	3.3%	2.9%

percent, indicating the use of carryover funds, as prior unspent resources were employed. As seen in Table 3.4, grants as percent of GDP rose from 33 percent in FY2004 to 46 percent in FY2007 and have slowly declined since that time, falling to 35 percent in FY2013, although the moratorium placed on capital grants in FY2012 reduced grant levels below trend. A similar pattern is observed in terms of grants as a percent of total revenues—rising to a high in FY2007 and then falling back during the remainder of the period covered by this review. With an increasing level of nominal GDP and stagnant level of Compact transfers, after the decrement and the two-thirds inflation adjustment, a declining trend is expected. Receipt of grants from other governments (mainly Taiwan) and federal programs has fluctuated during the Amended Compact but has displayed a downward trend.

87. Tax revenues as a percent of GDP grew in the early part of the Amended Compact, reaching a peak in FY2007, and since that time have displayed a gradual decline. This recent decrease reflects both discretionary changes in tax rates, the outmoded tax regime, and lack of tax buoyancy in the RMI. Tax efforts in the RMI are below that of the majority of other Pacific Island economies and below the rate prevailing in the United States. Public expenditure, including outlays on non-financial assets, has displayed a more stable pattern (except for FY2005) and has also shown a downward trend. In FY2013 total government expenditures fell to 57.2 percent of GDP, but this remains a very high level of government involvement in the economy by standard economic measures.

4. Structure of the RMI tax and revenue system

88. The tax regime in the RMI is based on a legacy tax system created before independence. The major source of tax revenue is a tax on wages, accounting for 39 percent of a total tax yield of $31 million in FY2013. The reduction in professional contractor presence on Kwajalein in FY2008 and a reduction in Marshallese employees were expected to erode the tax base, and a significant reduction was projected. However, nominal income tax receipts have largely remained consistent during the review period, and declining receipts from Kwajalein have been compensated for by increases in general economic activity. Wage earners pay 8 percent of income, up to a threshold of $10,400, and above that, 12 percent. Those earning less than $5,200 have a tax-free threshold of $1,560. Recent estimates of the wage tax buoyancy indicated a ratio of 0.77 to the tax base of compensation of employees. The wages tax is collected through employers but no individual's records are maintained by the tax authorities. The low buoyancy thus suggests weaknesses in compliance.

89. Customs duties provide the second most significant category in terms of tax yield, representing 25 percent of total taxes collected. In FY2004 the general rate of import duties was 8 percent, which has remained unchanged, although food items attract a lower rate, and there are wide ranges of exemptions for different categories of importers. In FY2005 new higher rates were imposed on "sin" goods, with the additional revenues earmarked for the CMI. In 2008, in a response to the high inflation in fuel and food prices, the government granted an import-duty exemption to the MEC for its imported diesel fuel (for generation and re-export) and to imports of basic food staples, such as rice and flour. The trend in import tax collections during the reporting period has been a negative 1.2 percent per annum, suggesting a negative buoyancy ratio, and that import taxes have provided a poor source of revenue to the government.

90. The gross receipts tax (GRT) represents 21 percent of total tax revenue and is levied at 3 percent of business turnover. It is intended as a proxy income tax, although the incidence is comparable to that of a sales tax. The tax suffers from a cascading effect, in which each sale from one business to another multiplies the tax yield and distorts resource allocation. Fish and fish products have been exempted from the GRT to enable the fishing sector to remain competitive in international markets. Estimates of the GRT buoyancy indicate a factor of 1.29, meaning for every one percent increase in the tax base, revenue grows by 1.29 percent. This shows that although the tax has many undesirable properties, it has provided government with an elastic source of revenue.

91. Tax holidays continue to be granted by the RMI in special cases, including exemptions on GRT for the existing fishing operations. To spur growth in exports and foreign exchange earnings, nations generally try to avoid taxing export-oriented business activities. This principle has not been adopted in the RMI, and several exporters, including the MEC, still pay GRT on their export revenues. Levies charged on the RMI ship registry, the third largest in the world, provide the remaining significant source of tax revenue. In FY2004 these levies generated $1 million in revenue for the RMI. Recent fee changes negotiated with RMI ship registry have enabled buoyancy from this source, which yielded $4 million in FY2013.

92. Of nontax revenues, fishing fees raised an average of $1.3 million during the FY2004-FY2009 period but were a volatile source, depending on the location of the fishing stock. Since FY2010, with the implementation of the Vessel Day Scheme (VDS) under the Parties to the Nauru Agreement (PNA), fishing fees increased to $7.9 million by FY2013. In addition to fishing fees, nontax revenues include a variety of smaller items, such as earnings on investments, administrative fees, and incidental sales.

E. Economic Prospects FY2014-FY2023

93. Given the current policy environment and experience of the first 10 years of the Amended Compact, this section looks at prospects for growth until FY2023 when direct financial assistance ends. It is important to look at the projected level of expenditure post FY2023, especially given the resources constraints the GRMI may face in the event of insufficient resources from the CTF to meet the needs of the GRMI. The projections outlined below are based on two broad sets of assumptions: (i) a continuation of existing trends and known future developments; and (ii) the set of policy changes agreed upon by the RMI leadership in response to the preparation by the GRMI of a decrement management plan (DMP). While economic performance during the first 10 years of the Amended Compact was driven by fishing and the delivery of public services, the DMP entailed a series of actions designed to maintain fiscal stability in the face of the declining real value of grants under the Amended Compact. The DMP entailed the following actions:

- Expenditure compression—reduction in departmental expenditures in three tranches programmed to take place in FY2016, FY2018, and FY2021;
- Tax reform;
- Use of MIMRA funds (fishing fees);
- Reduction in subsidies to the SOEs; and

- Reduction in transfers to Majuro landowners for utility payments.

1. Economic Activity

94. The baseline projection of economic activity is shown in Figure 3.16. The major factors affecting the projection relate to the fisheries sector, infrastructure investment, and the provision of public sector services. The fisheries industry has been an important generator of economic growth, but from FY2016-FY2023, it is projected to grow modestly. The output of the loining plant is constrained by labor shortages, and potential increases in off-shore purse seine operations are considered as nonresident. Some increase in home-based operations for the fish fleet is, however, anticipated as well as in the operations of MIMRA, the governmental entity managing the fishing resource.

95. In the case of construction, the use of the infrastructure sector grant under the Amended Compact has had a very significant impact on construction output. Once drawdowns under the grant had stabilized at the start of the Amended Compact, use of the grant averaged $12.5 million during the FY2005-FY2011 period. In FY2012, due to a moratorium placed on the use of the grant because of management issues, drawdowns fell to $5.4 million and were reduced further to $4.2 million in FY2013. In FY2015 and subsequent years, it is assumed that use of the grant will return to the normal annual level plus arrears. This should give rise to an increase in construction activity but a reduction in output, once the arrears have been exhausted.

96. The output of the supply of government services is assumed to be constrained by the fiscal environment of the diminishing real value of Compact sector grants under the Amended Compact. While the DMP included various expenditure adjustments, staffing reductions were confined to public administration. In FY2018 and FY2021, there are planned reductions in payroll of 4 percent and 5 percent, respectively. Meanwhile, the levels of staffing in education and health services are projected to remain unchanged.

Figure 3.16 GDP projections over the long term, annual percent change, FY2014-FY2023

97. Figure 3.16 indicates both level of GDP in constant prices and the annual growth rates through FY2023. The average GDP growth through the period is 0.5 percent, which is below the average growth of 1.8 percent between FY2004 and FY2014. There was a sharp uptick in economic activity in FY2015 as construction activity resumes, which will likely continue through FY2017. In FY2018 the first reduction in public administrative services under the DMP is planned to be implemented, and GDP will likely fall by 0.4 precedent. In FY2019 and FY2020 the unused infrastructure grant funds will likely be exhausted, and as a consequence construction output and GDP likely will decline. In FY2021 the third tranche of the DMP is planned to be implemented, and administrative services is reduced by a further 5 percent. From FY2022 to FY2024, the economy is predicted to grow at a steady state rate of 0.4 percent. While initially after FY2014 an economic stimulus is predicted, because of the assumed used of unused infrastructure grant funds, the later period prior to FY2023 will likely be less favorable, as the stimulus wears off and the DMP expenditure cuts are implemented.

2. Fiscal Projections

98. The revenue projections are based on performance in the economy, annual reductions of real grant values under the Amended Compact, and reforms specified in the DMP. While tax revenues increase as the economy grows, tax effort declines as a percent of GDP, due to the inefficient nature of the existing regime. The DMP includes implementation of the tax reform package that has been under consideration by the RMI leadership for some time. While the tax reform is designed to be revenue neutral, there are some revenue gains predicted in FY2018, the year of implementation, and going forward the more efficient nature of the reformed tax system is revenue positive.

99. Receipt of fishing fees by the RMI has grown rapidly in recent years. From a level of $3 million in FY2010, the revenues of MIMRA have grown to $15 million in FY2013. This significant growth reflects the impact of the Parties to the Nauru Agreement (PNA) and the introduction of the Vessel Day Scheme (VDS). From a level of $5,000 per fishing day prevailing in 2013, the PNA has agreed that in 2015 the rate will increase to $8,000. In years prior to 2010, the MIMRA resources were used to support the development and sustainability of the fishing industry. However, with the significant growth in fees and the return on a national resource, the revenues present a major fiscal resource. While a minor portion of the resources had been programmed into the budget, the additional fees have not formed part of the annual budgeting process. The DMP thus specified that 80 percent of fishing fee revenue will be transferred to the RMI general fund, leaving the remaining 20 percent to support development of the fishing industry.

100. On the expenditure side of the equation, payroll expense has been assumed to be moderated by not increasing current staffing levels but allowing modest increases in wage rates that are at or below cost of living increases. As noted, the DMP includes planned reductions in administrative staffing of 4 percent and 5 percent in FY2018 and FY2021, respectively. Expenses on goods and services are projected to remain constant in real terms but to be reduced during the three tranches of the DMP, amounting to a total of 8 percent of ministerial outlays in the remaining Amended Compact period. Two further expenditure reducing measures were included in the DMP: a reduction in the level of subsides to SOEs of 20 percent, phased in

FY2016 and FY2018; and a reduction in transfers to Majuro landowners, in respect to utility bills, by 50 percent, to be phased in equally during the three tranches.

101. Figure 3.17 indicates the projected deficit as a percent of GDP and domestic financing requirements. After implementation of the DMP in FY2015, the fiscal deficit is expected to improve, and a surplus is recorded. The position improves throughout the remaining period of from FY2015-FY2023, and an average surplus of 3 percent of GDP is achieved. Domestic financing indicates the level of financing required from domestic sources to fund the deficit. In FY2014 before adjustment, funding the government requires $4 million. However, from FY2015 onward, the government is projected to accumulate funds averaging $4 million a year and totaling $34 million between FY2016 and FY2023. The GRMI needs to commit to implementation of the DMP to achieve these targets. However, the projections indicate that savings would be available to the GRMI, should it fully implement the DMP as described above.

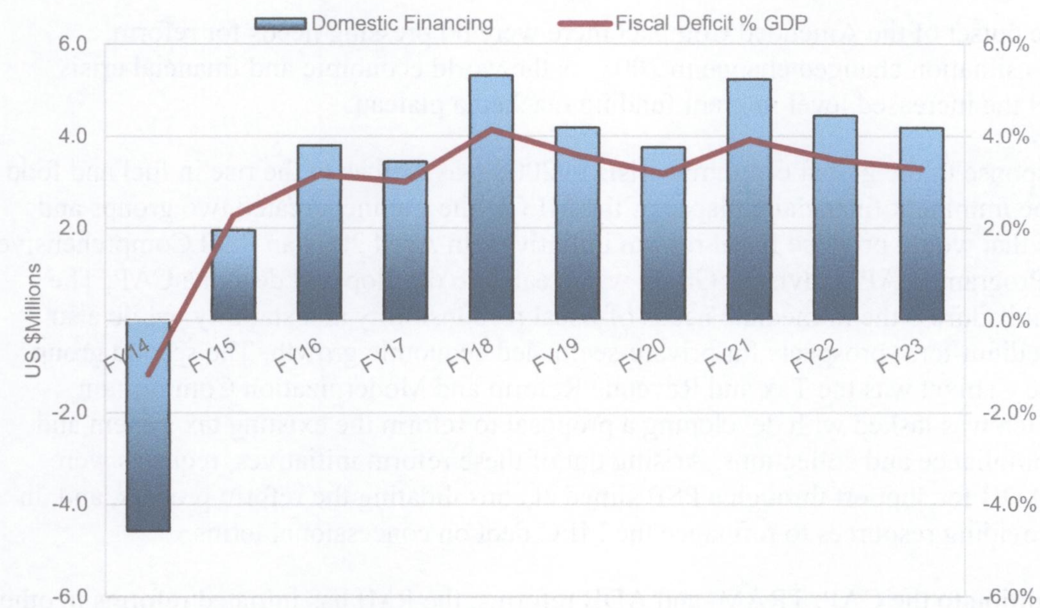


Figure 3.17 Projected fiscal deficit and domestic financing, FY2015-FY2023

IV. Policy Reform

102. At the start of the Amended Compact, there was no existing policy framework or strategic plan to guide development of the RMI or allocation of resources. The Amended Compact contained no requirement for an overarching framework to guide policy or inform the annual budget process. Rather, the Amended Compact required that the RMI adopt a medium-term framework for the preparation of the annual budget and for the request for resources from the U.S. under the sector grants.

> *The Government of the Republic of the Marshall Islands shall prepare and maintain an official medium-term budget and investment framework. The framework shall be strategic in nature, shall be continuously reviewed and updated through the annual budget process, and shall make projections on a multi-year rolling basis.*

103. At the outset of the Amended Compact there were no pressing needs for reform. However, this situation changed change in 2008, as the world economic and financial crisis unfolded, and the increased level in grant funding reached a plateau.

104. In response to the global economic crisis in 2008—as well as to the rise in fuel and food prices, and the imminent financial collapse of the MEC—the Cabinet created two groups and commissions that would produce fiscal reform initiatives. In April 2009 an RMI Comprehensive Adjustment Program (CAP) Advisory Group was created to develop and design a CAP. The program would address the immediate needs of fiscal responsibility and stability, while also enhancing medium-term prospects for private-sector-led economic growth. The second group created by the Cabinet was the Tax and Revenue Reform and Modernization Commission (TRAM), which was tasked with developing a proposal to reform the existing tax system and strengthen compliance and collections. Arising out of these reform initiatives, requests were made to the ADB for support through a PSP aimed at consolidating the reform process, and, in particular, providing resources to refinance the MEC debt on concessional terms.

105. In addition to the CAP, TRAM, and ADB reforms, the RMI has initiated reforms in other areas: state-owned enterprise (SOE) framework legislation; external debt management; information and communications technology reform, supported by the World Bank; fiscal responsibility; public service commission reforms; and decrement management planning. In 2014, toward the end of the first 10 years of the Amended Compact, the RMI published a *National Strategic Plan for 2015-2017* to guide resources allocation over the medium term. This section is intended to provide a status report on the progress of these policy reforms and initiatives pursued by the RMI.

A. Public Sector Reform

1. Public Sector Payroll

106. The number of civil servants increased from 1,892 in FY2003 to 2,400 in FY2008, at an annual rate of growth of 3.1 percent. Since FY2008, the size of the public service has grown very modestly, adding another 33 jobs, or at an annual rate of 0.2 percent (see, Figure 4.1).

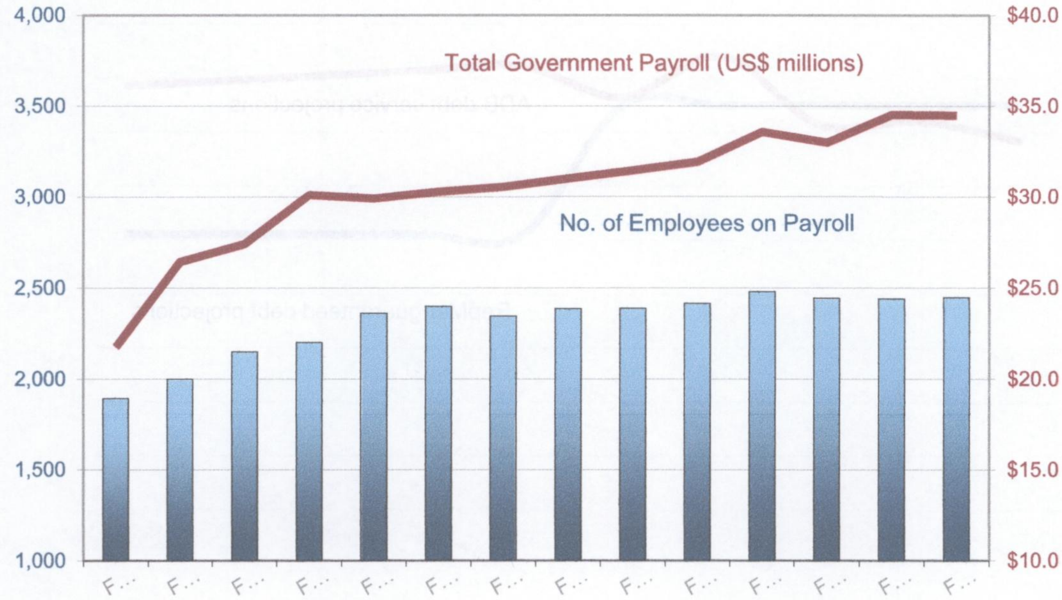


Figure 4.1 RMI government payroll cost and number of public servants, FY2003-FY2016

107. Although expansion in government payroll has moderated since FY2008, total government payroll costs have continued to expand, reflecting overall increases in wage rates across the RMI. While a policy of freezing payroll costs has been in place during much of the period, a hidden 1.3 percent annual wage drift has occurred. In FY2013 salaries for teachers and nurses increased, due to improvements in teacher qualifications and higher pay scales to retain nurses moving to better-paid locations. Moderate annual increases in wage rates can represent sound policy intended to attract and maintain a qualified workforce. However, this pattern has added to the overall cost of government, in an environment with limited fiscal space. Over the reporting period, payroll numbers have increased at an annual rate of 2.3 percent, while payroll costs rose at an average rate of 3.9 percent.

108. Although the recruitment process now appears to be under control, the extent of the expansion in government since the reduction in force (RIF) at the end of the 1990s suggests that there is significant overstaffing. After the RIF, there were 1,700 public servants (including an allowance for the SEG), compared with the current level of 2,400. Thus, it appears that there is considerable scope for "right" sizing to establish a level of staff that adequately maintains government services.

109. In addition to the general analysis of trends in the civil service, employment by funding source adds further insight. Figure 4.1 indicates the level of public servant employment by fund type. The general fund has grown by 266 jobs or 2.8 percent per annum. Meanwhile, employment in the Compact grant-funded sectors has increased by 135 jobs or 1.4 percent per annum. Another area of major growth has been in federal programs employment, which has grown by 73 jobs or 3.7 percent per annum. While analysis indicates that the Amended Compact allowed for significant growth at the start of the period, financed through the Compact sector grants, in later years, the general fund has provided the major source of growth with federal programs—which are not subject to the same domestic fiscal pressure—making an important contribution to overall employment composition in the RMI.

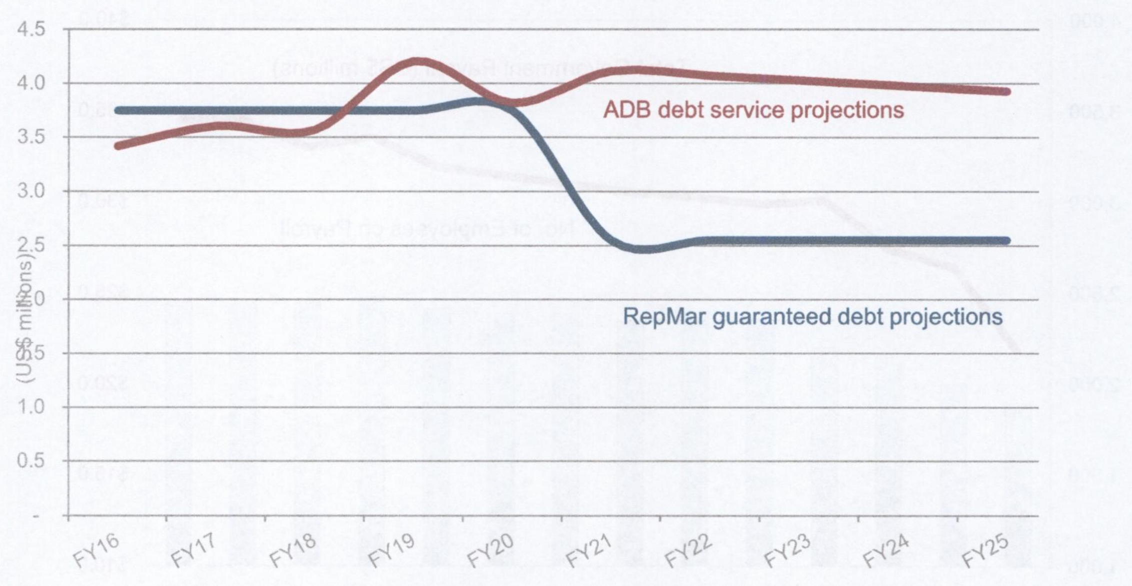


Figure 4.2 RMI debt servicing projections, government and SOEs, FY2016-FY2025

2. External Debt Management

110. External debt management has presented a major challenge. There are two main components of debt service: government debt on concessional terms to the ADB, and government guaranteed debt incurred by the SOE sector. Figure 4.2 indicates the projected trend in debt service for the two types. External debt of the SOEs is at higher interest rates and shorter terms and thus incurs a proportionately higher service commitment. Debt service of the National Telecommunications Authority (NTA) and Marshalls Energy Company (MEC) are projected in FY2014 to be $2.6 million and $0.6 million, respectively. The financing of the new fiber-optic cable through extension of the existing U.S. Department of Agriculture (USDA) Rural Utilities Service (RUS) facility has placed the NTA in a precarious financial position, requiring grants and loans from the government to remain operational. In the case of the MEC, the outstanding debt of $6 million, also to the RUS, is due to be fully paid down by FY2021[6]. Once the MEC debt is repaid, the NTA will be the only remaining SOE with external, debt-service obligations.

111. For debt to the ADB, the government will be required to set aside on average between $3.2 million and $4.2 million from the general fund for the next 15 years. This currently represents slightly less than 10 percent of the $43 million of general fund revenues. In previous years, nearly all of the RMI debt was in the grace-period era, and debt service obligations were not significant. However, in the last five years, principal repayments for many of the loans have fallen due, and debt service has contributed to considerable fiscal pressures.

112. In FY2006 the RMI government experienced its first problems in servicing ADB debt and defaulted on several loans. In FY2007 it remained in arrears, as service obligations rose to

---

6 The recent ADB PSP loan to government was on-lent to the MEC to refinance its costly loan from the Bank of Guam with concessionary finance. The PSP loan is classified under ADB debt to government.

$2.2 million. By FY2008 the government placed ADB debt service higher on its payment priority schedule. It has paid past delinquencies and is currently up to date. However, the requirement to make large payments periodically continues to cause cash flow problems. The ADB debt service crisis has brought attention to the impact of a poorly managed external debt strategy. A well-articulated debt management strategy is needed to assist the RMI in determining the type of projects for which external loan finance is appropriate and the capacity to identify cases where there is potential for projects to cover service costs. While such a debt management strategy has been developed and adopted by the Cabinet, it has now been waiting for several years for commitment by the Nitijela to enact the policy into law.

3. Public Expenditure and Financial Accountability

113. In late 2010 the RMI invited the Pacific Financial Technical Assistance Center (PFTAC) to assist it in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment for the national government. The PEFA is a framework for the assessment of public financial management (PFM), developed by the World Bank and a group of international donors in 2005, which has subsequently been updated[7]. It has been implemented in many countries around the world and provides an objective yardstick by which countries can assess and improve their PFM performance. The framework has six broad categories:

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

Each of the six major areas is divided into 28 high-level indicators, which, in turn, are further subdivided. The scoring system is based on international standards and provides a precise measurement system.

114. In December 2011 the RMI underwent a formal or external PEFA assessment. A team of assessors comprised of PFTAC, the World Bank and members of the RMI government, assisted by a PEFA expert, completed the assessment. Comments on the assessment were provided to PFTAC, and a final report was prepared. The Cabinet adopted the report and directed PFTAC to prepare a "road map." The road map will identify areas in PFM that are in need of improvement and reform and focus efforts on the more critical components. This will outline a program of

[7] *Public Expenditure and Financial Accountability,* PEFA Secretariat, Washington D.C., 2011 revised.

Table 4.1 CAP Advisory Group proposed savings by expense category

REFORM AREAS	MINIMUM SAVINGS (US$ millions)	MAXIMUM SAVINGS (US$ millions)
Civil service	1.7	4.9
Nitijela member compensation	.14	.17
Housing allowances	.25	.27
Electricity allowances	.5	1.52
Leased and rental housing	.07	.15
Utility bills	.25	.75
Communications	.05	.1
Vehicles	.05	.1
Fuel	.07	.1
Travel and per diem	.1	.2
Professional services	.03	.06
Grants and subsidies	.6	1.8
Organization/facilities consolidation	.15	.3
TOTAL	**3.96**	**10.42**

technical assistance. However, since the formal PEFA assessment, no progress has been achieved in the development of the road map.

4. THE COMPREHENSIVE ADJUSTMENT PROGRAM (CAP)

115. The Minister of Finance, with the endorsement of the Cabinet, created the CAP Advisory Group on April 22, 2009. Two broad goals were identified for the program: (i) to put the government on a path toward long-term fiscal sustainability; and (ii) to provide the government with a program that can better guide its relations with the external donor community. The CAP Advisory Group outlined general principals of reform, but these were limited to cost reduction and a detailed examination of the major areas of expense. Table 4.1, reproduced from the CAP report, indicates a lower and upper range of potential savings by expense category.

116. In the RMI, the civil service represents nearly 40 percent of the cost of current operations. The advisory group recommended the implementation of a RIF, ranging from 50-400 civil servants, with a cost savings of $0.7 million to $5.6 million. It is clear that any RIF would have to come from the general fund, as other categories are protected by dedicated funding sources. At the time of the reforms in the late 1990s, the general fund supported about 600 staff outside of education and health. Since that time, employment financed by the general fund has grown by about 300. The reduction in cost savings represented by the upper bound of the CAP in Table 4.1 corresponds to approximately this level, i.e. about 300 civil servants. The target is thus at the upper end of what is feasible.

117. The CAP study did not directly make any recommendations regarding the savings that could be generated from a reduction in subsidies and transfers to the SOEs and other government agencies. As noted above, the CAP did recommend a review of the SOE sector. This review, now completed by the ADB[8], recommends development of a comprehensive approach. Clearly,

8 *Review of Public Enterprises and Options for Reform*, Asian Development Bank, Manila, 2010.

these suggested savings are not easily achieved without disrupting delivery of existing government services, many of which support disadvantaged groups in the outer atolls. However, while the CAP did not directly specify a target reduction in subsidies, the sector is certainly an area where costs have risen very significantly, and long-run cost savings could be realized.

118. Overall, the CAP group recommended expenditure reductions of $7 million to $8 million over a one-to-three-year period to address the structural deficit. However, none of the CAP recommendations have been implemented. Recent budgets since the CAP review, FY2010 through FY2014, have recommended a series of across-the-board wage freezes or budget cuts. None of the budgets were consistent with the CAP recommendations. The nonspecific reductions that have prevailed in the last five budgets are exactly the type of approach to revenue loss that the JEMFAC request for a DMP was designed to avoid. Decrement management was intended to be an approach to maintaining output delivery through efficiency gains, prioritization of key services, and reduction in or elimination of nonessential services. The implementation of the DMP is designed specifically to avoid an ad hoc approach and going forward will help provide a sound approach to budget management.

5. Asian Development Bank Public Sector Program Loan

119. Based on the reform initiatives developed by the CAP Advisory Group, the TRAM, and the SOE report endorsed by the Cabinet, the ADB engaged in negotiations with the government to develop a Public Sector Program (PSP) loan. The first tranche of the loan was $9.5 million, of which $8.4 million was devoted to refinancing the existing MEC debt with the Bank of Guam. The balance of the loan, just over $1 million, was initially held by the government. However, after some negotiations it was transferred to the MEC in early FY2011 for additional support. The second tranche, $5 million of general budgetary support, was conditioned on progress with attainment of the loan covenants. The loan became effective in September 2010, but review for the second tranche release was delayed until the end of 2013, when the additional funds were released. The PSP is designed to support the government in achieving its reform initiatives through the delivery of the following five outputs:

- improved medium-term fiscal outlook,
- restraint of recurrent expenditure,
- increased tax revenue,
- improved SOE performance, and
- increased stakeholder participation.

120. A comprehensive assessment of the PSP is made in the FY2012 RMI economic review[9]. A brief summary follows:

- ***Fiscal consolidation:*** Some progress was achieved, although none of the quantitative targets were reached. While the program fiscal surplus target of 3 percent was not attained, a surplus was achieved in FY2010 and FY2011. Contributions to the CTF were

[9] See *RMI Economic Review FY2012*, Graduate School USA, Honolulu, 2013.

made but were below target. Reductions in payroll were not met, although a wage freeze was implemented. Proposed reductions in subsidies to the SOEs were not implemented, and the ratio of capital expenditures to GDP fell, due to reductions in the Compact infrastructure grant. Increases in tax effort were not attained.

- ***Expenditure constraint:*** None of the CAP reforms were implemented, and although the level of expenditures to GDP remained at 50 percent in FY2010 and FY2011, it rose to 54 percent in FY2012.
- ***Tax reform:*** The tax reform initiative has not been implemented. However, it is still under consideration.
- ***SOE reform:*** This component of the program focused on the MEC. There is no doubt progress has been made, and the restructuring of the former costly commercial debt helped ease financial pressures. However, long-term financial sustainability of the MEC will only be attained once tariffs reflect the full cost of operation.
- ***Stakeholder participation:*** Efforts were made, although not sufficiently, to achieve a better result with program implementation.

6. Fiscal Responsibility

121. After the first two years of the Amended Compact, when the economy adjusted to the new fiscal arrangements, an average fiscal surplus of 1.4 percent was attained in all but one year between FY2006 andFY2013. In an economy such as the RMI, where there is no central bank or access to capital markets, expenditures must be held within the limits of available revenue. Shocks to the economy and the need for financing can be supported only through drawing down on cash reserves, or such measures as aging payments to vendors, defaulting on debt, or failing to pay monthly tax and social security allotments on behalf of employees. Thus, while fiscal balance may appear to have been achieved, the underlying position may be quite different, hiding a structural deficit and tight cash flow.

122. Recent estimates from the "Performeter," an indicator of financial health[10], indicates a "quick" ratio of cash-to-current liabilities for the general fund, averaging 15 percent during the review period. During the financial crisis in the RMI (FY2007-FY2009), the quick ratio averaged a mere 6 percent, indicating that the government had only six cents for every dollar to meet current obligations. In FY2012, the latest year for which estimates were made, the ratio stood at 16 percent. In addition to the quick ratio, there are many other signs of weakness that suggest that cash management still remains fragile. These signs include:

- the existence of a priority list of recipients, and weekly, cash-flow management;
- continuing problems with making timely debt service obligations to the ADB;
- the use of the majority of the Taiwan project fund ($7.4 million in FY2012) for general fund purposes; and

---

10 *RMI Performeter*, Crawford and Associates, Graduate School USA, Honolulu, 2012. See http://performeter.pitiviti.org for additional details.

- low or negative unrestricted balances of the general fund. (During the Amended Compact period, only in FY2011 was a positive unrestricted balance achieved, and in FY2013 it was -$0.1 million. In the worst year, FY2007, an unrestricted balance of -$26 million was recorded.)

123. In many countries public financial management is regulated through a fiscal responsibility act. In the RMI a Fiscal Responsibility Bill has been drafted and is under consideration—but has yet to be acted upon by the Nitijela.

7. SOCIAL SECURITY SUSTAINABILITY

124. A recent actuarial report[11] prepared for the RMI Cabinet on the status of the Social Security investment fund and options to improve long-term sustainability indicated that:

The current System design was put into place when expected benefit payments were a fraction of the expected contributions. The goal was that, by the time the benefit payments exceeded contributions, system assets would be built up enough so that investment income would make up the difference. Due to a maturing group of beneficiaries and a decreasing workforce, the current design is no longer sustainable.

125. Table 4.2 indicates the status of the valuation of the fund conducted for 2011. Total accrued liabilities amounted to $287 million, in comparison to a market value of investments of $65 million. The fund thus has an unfunded liability of $223 million or 23 percent. Figure 4.3 projects the Social Security fund status, contributions, and benefits over the 2013-2025 period. The last actuarial update was completed in October 2011. Since then the level of fund status has improved from the $65 million in 2011 to $73 million in 2013. The figure indicates the widening gap between contributions and benefits, from $4 million in 2013 to $16 million in 2025. As a result, the Social Security fund will decline at an increasing rate, until all reserves are exhausted in 2025. Contributions have been predicted based on the projected level of wages and salaries that were estimated as part of the decrement management planning effort. Projections of Social Security benefits have utilized the 2011 actuarial study. The projections of the value of the fund are based on the 2013 level, assuming a 7.5 percent return, which is the rate used by the actuaries.

126. A variety of reforms have been proposed in the recent actuarial report to rectify the collapsing fund status. The draft reform legislation pending with the Nitijela proposes four basic changes to the system, which include: 1) increases in the tax rate, from 7 percent to 9 percent; 2)

Table 4.2 Social Security valuation during 2011 (US$ millions)

	2011
Active Workers Earning Benefits	120.4
Retirees, Spouses, Children, and Disabled Workers Receiving Benefits	145.6
Fully or Service Insured Inactive Workers Entitled to a Future Benefit	21.4
Total Accrued Actuarial Liability	287.3
Market Value of Assets	-65.0
Unfunded Actuarial Accrued Liability	222.3
Funded Percent	23%

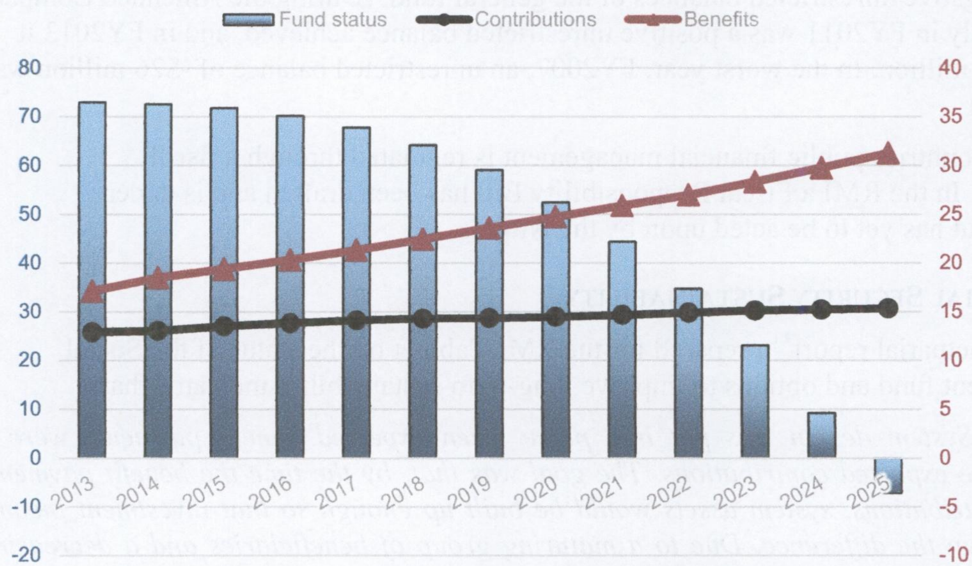


Figure 4.3 Social Security fund balance, contributions and benefits, FY2013-FY2025 (US$ millions)

an increase in the retirement age, from 60 to 65; 3) an extension of the quarterly earnings limit, from \$5,000 to \$7,500; and 4) a reduction in benefits of 22 percent. The impact of the proposed changes is shown in Figure 4.4. The reduction in benefits by 22 percent has the strongest impact, with the fund status rising through 2022 but thereafter declining. Increases in the tax rate to 9 percent also strongly impact the fund status, which rises up to year 2020 before declining. Extending the retirement age to 65 and increasing the maximum taxable quarterly earnings have beneficial impact but to a lesser degree. Clearly, no one reform on its own achieves sustainability in the sense that the fund is projected to decline at some future point. However, combining all the reforms in the legislation certainly has a powerful overall impact, and the fund achieves sustainability, rising to nearly \$250 million by 2025, the year in which the fund would otherwise collapse if no changes are made.

127. The package proposed results in the value of the fund rising to \$250 million by 2025, which, although no target level of unfunded liability has been set or risk analysis undertaken, would seem to more than cover the needs. Because of the unpopularity of the reform package proposed and in draft legislation, the RMI leadership has not yet acted on what is a growing financial and social problem. The fiscal resources available to the government are insufficient to finance the deficit. In the absence of action, future beneficiaries of the system are at best likely to receive only 50 cents on the dollar.

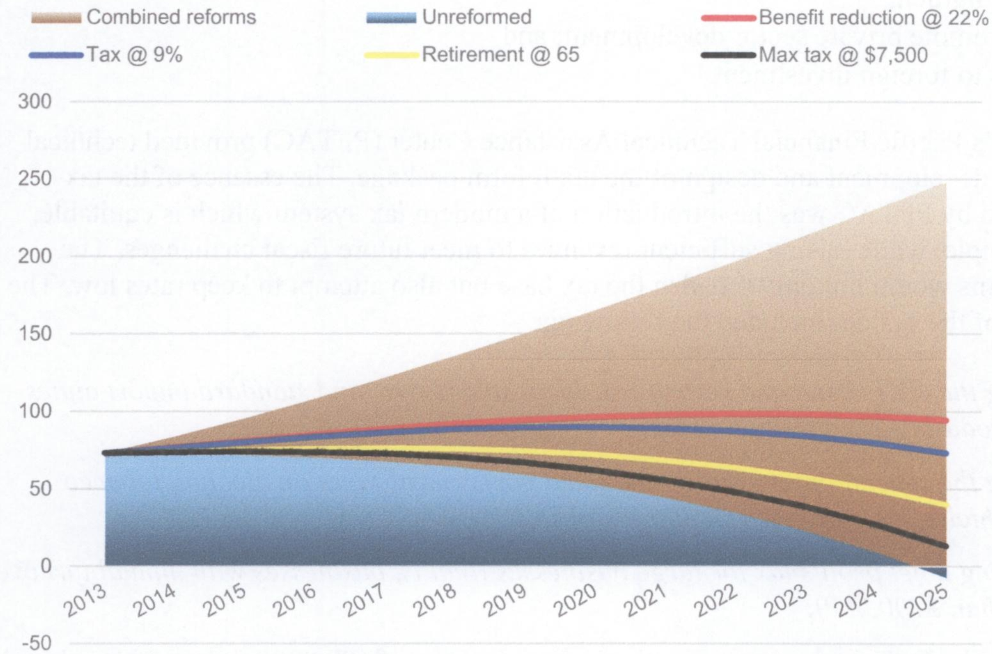


Figure 4.4 Impact of Social Security reforms on fund status, FY2013-FY2025 (US$ millions)

B. Tax Reform

128. The RMI government created the Tax and Revenue Reform and Modernization Commission (TRAM) on July 11, 2008. The TRAM was created to:

- *deliver to the Government for its consideration a* ***proposal to reform the current tax system and structure*** *to meet the current and future financial needs of the Republic of the Marshall Islands and a tax and revenue design conducive to current realities and circumstances;*
- *deliver to the Government a proposal to* ***strengthen the capabilities and effectiveness of the revenue collecting administration****, sufficient to implement the revenue and tax reforms and improve the level of (voluntary) compliance of RMI taxpayers; and*
- *take responsibility for governing and oversight of the design* ***to ensure effective implementation*** *of the changes needed to enhance a sustainable revenue stream to the Government.*

129. In its proposal the TRAM adopted the following guiding principles for tax reform. The tax measures must be:

- transparent and certain;
- effective and efficient to administer;
- simple and broad-based;
- fair and equitable;
- financially neutral;

- a low tax burden;
- able to promote private sector development; and
- attractive to foreign investment.

130. The IMF's Pacific Financial Technical Assistance Center (PFTAC) provided technical assistance in the development and design of the tax reform package. The essence of the tax reforms proposed by PFTAC was the introduction of a modern tax system which is equitable, efficient, and simple, while raising sufficient revenues to meet future fiscal challenges. The package of reforms would not only broaden the tax base but also attempt to keep rates low. The major elements of the system included the following:

- *replacing the GRT, hotel and resorts tax, local sales taxes, and standard import duties with a broad-based consumption tax;*
- *replacing the special import duties and local government taxes on alcohol, tobacco, motor vehicles, and fuel with similar excises;*
- *introducing a net profits tax for large businesses (that is, businesses with annual turnover greater than $100,000);*
- *retaining the GRT for businesses with turnover less than $100,000 but increasing the rates in certain cases; and*
- *modifying the wages and salaries tax by broadening the tax base to include items which are currently exempt, modifying and expanding the current tax-free threshold so that it is available to all taxpayers, and introducing a higher tax rate for high-income earners.*

131. While the PFTAC proposal outlines a set of reforms, it also stresses the need for the strengthening of tax administration. The PFTAC also proposed the creation of an independent tax authority, which would incorporate an efficient and incentivized administration not subject to public service regulation. The tax reform strategy and administrative reforms would provide the RMI with a tax system consistent with international standards that is conducive to business and foreign investment and is more equitable for taxpayers. The proposed reforms would also increase the revenue yield. To date, the PFTAC proposal has not been adopted by the GRMI.

132.

C. Private Sector and State-Owned Enterprise Reform

1. State-Owned Enterprises

133. The SOE sector is particularly important in the RMI and poses a significant risk to financial management. The average subsidy level during FY2011-FY2013 was $7.7 million, representing 21 percent of the national government's domestic revenues. If capital transfers are included, these figures rise to $9.2 million and 25 percent, respectively. Figure 4.5 provides estimates of the average level of operating income and subsidy received during the period for each of the major entities:

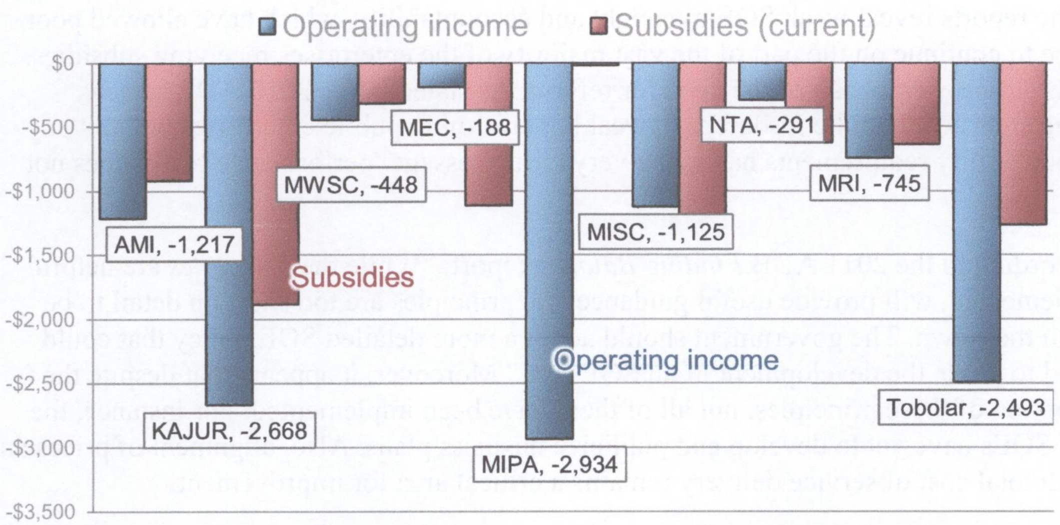


Figure 4.5 State-owned enterprises, subsidies, and net operating profit, average FY2011-FY2015 (US$ thousands)

- ***Air Marshal Islands (AMI):*** responsible for operating domestic airline services to the outer atolls; average level of operating subsidy, $0.8 million, or $1.8 million including capital transfers.
- ***Kwajalein Atoll Joint Utility Resources (KAJUR):*** provides power, water, and sewer services to Ebeye; average level of subsidy, $1.9 million.
- ***Majuro Water and Sewer Company (MWSC):*** provides water and waste management to Majuro; average level of subsidy, $0.2 million.
- ***Marshalls Energy Company (MEC):*** provides power to Majuro and operates wholesale fuel distribution mainly to shipping vessels; average level of subsidy, $1.1 million, of which $0.8 million was received from the government for operations in the outer atolls.
- ***Marshall Islands Shipping Corporation (MISC):*** provides shipping services to the outer atolls; average level of subsidy, $1.3 million.
- ***National Telecommunications Authority (NTA):*** serves as the national telecommunications provider; average subsidy received, $0.2 million, or $0.6 million if capital transfers are included.
- ***Marshalls Resort Inc. (MRI):*** operates a resort hotel in Majuro; average level of subsidy, $1 million.
- ***Tobolar Copra Processing Authority:*** collects copra from the outer atolls and produces coconut oil, as well as some coconut products; average level of subsidy, $1.2 million.

134. It needs to be recognized that these subsidies entail a substantial level of support to rural and disadvantaged communities in the outer atolls. Thus, the SOE issue is not that the subsidies should be eliminated but rather that they be reduced and managed in an efficient manner. Two recent ADB reports[12] highlight significant weaknesses in the RMI's SOE governance and policy

12 *Review of Public Enterprises and Options for Reform*, Asian Development Bank, Manila, 2010; and *Finding Balance – Regional Report*, Asian Development Bank, Manila, 2011.

regimes. The reports reveal weak SOE oversight and accountability, which have allowed poor performance to continue on the part of the vast majority of the enterprises receiving subsidies. Both reports strongly emphasized the need for reform. As stated in the 2010 ADB review, "transferring significant public resources to weakly performing public enterprises without any strong accountability requirements has sent a very clear message: performance really does not matter."

135. According to the 2011 ADB *Finding Balance* report, "While the *principles* are helpful and, if implemented, will provide useful guidance, the principles are too short on detail to be sufficient on their own. The government should adopt a more detailed SOE policy that could then be used to guide the development of an SOE Act." Moreover, it appears that despite the official adoption of these principles, not all of them have been implemented. For instance, the majority of SOEs have yet to develop and publicize business plans. Also, alignment of prices and charges with total cost of service delivery remains a critical area for improvement.

136. With ongoing technical support from the ADB, a new SOE policy was drafted, adopted by the Cabinet in late 2011. Subsequently, the legislations passed in October 2015, and was amended in 2016. These efforts notwithstanding, it is clear that significant technical and financial resources, political will, and time will be necessary to see real changes in the governance and performance of SOEs in the RMI.

2. World Bank's 'Ease of Doing Business Survey'

137. The World Bank's "Ease of Doing Business Survey" provides a general assessment of the environment for private sector development. Table 4.3 indicates the RMI's ranking for each of the 10 major categories, which has continued to steadily deteriorate in the majority of these categories. While little action has been taken over the period to improve the business environment, the declining score suggests that other nations have actively pursued reforms. Overall, the RMI currently scores 140 out of a total of 189 countries. The RMI's scores are generally weak. Registering property scores 189, the worst of all countries surveyed by the World Bank, while for protecting minority investors, the RMI ranks 178. Resolving insolvency is also poor, at 167. The RMI registers its best score of 63 for dealing with construction permits.

D. Adjustment to the Amended Compact

Table 4.3 RMI: 'Ease of Doing Business,' World Bank ranking

Category	2012	2013	2014	2015	2
'Ease of Doing Business' overall rank	106	101	139	140	
Starting a business	52	48	70	71	
Dealing with construction permits	8	4	10	63	
Getting electricity	76	73	68	125	
Registering property	183	185	189	189	
Getting credit	78	83	71	79	
Protecting investors	155	158	183	178	
Paying taxes	96	92	128	125	
Trading across borders	66	65	68	75	
Enforcing contracts	63	66	58	65	
Resolving insolvency	135	140	168	167	

1. Decrement Management

138. In September 2009 the JEMFAC requested the RMI to prepare a decrement management plan over the medium term, to provide an adjustment strategy to the growing structural deficit implicit in the Amended Compact due to the annual decrement. At the JEMFAC meeting in September 2009, the JEMFAC through a series of resolutions called for the RMI to develop a plan for managing annual decreases in direct assistance under the Amended Compact. Beginning in 2011, when the RMI submitted its MTBIF to JEMFAC, and over the next several years, the United States and the RMI worked through the JEMFAC and additional resolutions on the RMI's MTBIF, especially with respect to bringing the RMI's budget request in line with the commitments in that document and culminating the RMI crafting the DMP, which was endorsed by the Cabinet and submitted to the JEMFAC.

139. The approach adopted by the MTBIF was a simple one: to implement reform efforts to reduce expenditures and adopt a modern tax regime. The subsequent improved fiscal position would enable education and health expenditures adopted as priorities by the RMI government to be maintained in real terms over the medium term as the rest of the government was scaled back.

E. *Planning Initiatives*

1. The Medium-Term Budget and Investment Framework

140. The Amended Compact requires no overarching policy framework or strategic plan to set development policy, guide the allocation of resources, or inform the annual budget process. Rather, the Amended Compact specified that the RMI should adopt a medium-term framework for the preparation of the annual budget and for a request for resources from the U.S. under the sector grants. While the adoption of a medium-term framework is standard practice in public financial management, this is usually subjugated to a higher level statement of national policy. The RMI system was termed the MTBIF, and is reflected in the language of section 211(f) of the Amended Compact, which states:

> *The Government of the Republic of the Marshall Islands shall prepare and maintain an official medium-term budget and investment framework. The framework shall be strategic in nature, shall be continuously reviewed and updated through the annual budget process, and shall make projections on a multi-year rolling basis.*

141. The MTBIF is described in government planning documents as a five-year, medium-term budgeting framework. It contains two past review years, the current fiscal year, and two future trend years. The MTBIF is supposed to be updated twice annually—in December and February—to identify budget envelopes for the following fiscal year, based on past trends, expected needs, and performance. The intention is to update the MTBIF midyear to include previous fiscal-year audit information. As part of the process, an MTBIF Policy Framework Paper is required to provide macroeconomic and fiscal guidance. The paper is intended to highlight major trends, such as revenue and expenditure issues, and other macroeconomic issues that the government and/or economy may be confronting in the medium term.

However, while the MTBIF approach was written into the Amended Compact, and the framework was initially updated annually, the process has not been adopted as a meaningful budget planning tool or active component of fiscal and macroeconomic planning. This is the result of a series of factors. First, there has been a lack of institutional capacity to build and maintain the MTBIF within the Economic Policy, Planning, and Statistics Office (EPPSO). The MTBIF was originally prepared by nonresident consultants, and there has been no local staff tasked with managing, updating, or communicating the results of the process to policy makers during the budget cycle. Second, there has been a lack of up-to-date fiscal information upon which to base the framework. While audit statements are produced each year, they become available only at the end of June, when budget design is well-advanced. Budgets are thus forced to be designed budget-on-budget. In the absence of last year's actual fiscal results, budgets are made in relation to last year's allocation—a process that is hardly conducive to the efficient allocation of resources. Third, macroeconomic data has until lately constrained the construction of a typical macroeconomic framework, which comprises the national accounts, statement of government operations, balance of payments, and monetary survey. These statistics have now been available for several years, and the RMI has the tools to develop a standard macroeconomic framework with projections over the medium and longer term through the remainder of the Amended Compact.

2. The National Strategic Plan 2015-2017

142. The government of the RMI prepared and published the National Strategic Plan 2015-2017 in May of 2014 with support from the United Nations It was developed using a collaborative process with representation from stakeholders and all segments of the RMI economy. In essence, the NSP is a consolidation of policy statements, plans, and miscellanea, from government departments, agencies, and a variety of segments of the RMI community. The executive summary of the NSP states:

> *The NSP is designed as a framework to coordinate the articulated medium term development goals and objectives of the RMI government at the national level. The NSP will be used by government leaders as the roadmap for development and progress in the medium term (2015-2017) and will be continually updated for use in meeting longer term objectives as the RMI moves towards the scheduled completion of The Compact of Free Association, as Amended funding in 2023.*
>
> *The initial NSP outlook is three years (FY15-17). The NSP has been developed in coordination with the RMI planning and budgeting cycle. As such, the NSP is designed as a three year rolling plan.*

143. Broadly, the NSP is more like a list of policy objectives and aspirations than an operational document for use in budgeting. Only in the case of the Education Department does the NSP provide a performance matrix containing strategies, outcomes, and monitoring indicators. With the limited manpower available in the RMI, it is difficult to envisage fulfillment of the annual updating required. If publication of the NSP had occurred with reinitiation of the MTBIF, the NSP could have provided the overarching framework that is currently lacking in the Amended Compact and RMI planning system. As such, the NSP can only provide an indicative framework for planning.

F. Policy Reform Summary

144. This section provides a selected summary of various components of the RMI's policy and institutional structure that have been part of the reform agenda and have been discussed in this review.

145. ***Fiscal Policy:*** In the fiscal policy area, the RMI has generally achieved fiscal balance since the initial adjustment to the Amended Compact. Payroll costs rose significantly at the start of the Amended Compact, as funding levels increased. Since that time, payroll cost has been kept under control. The external debt profile at the start of the Amended Compact was high and might have been considered at risk. However, progress has been achieved in bringing the debt to GDP ratio down. Long-term fiscal adjustment and reforms under the CAP to address the mid-2000s crisis were not implemented once fiscal pressure moderated, despite the continuing need. The ADB PSP was partially implemented, although reforms at the MEC were the bright spot. The DMP was crafted in June 2014, and the initial requirement to incorporate MIMRA fishing fees into the budget at 80 percent of excess funds above MIMRA core programs was implemented. The Social Security system faces a rapidly deteriorating financial position and eventual collapse—potentially before FY2023. Reforms to strengthen the fund have been proposed but have not been acted on. This is an area of increasing concern.

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

147. ***Public Financial Management:*** The RMI initiated a program to adopt the World Bank and IMF standard of Public Expenditure and Financial Accountability (PEFA) as a means to improve PFM. However, after an external assessment was conducted, no further progress has been achieved. Financial accountability has undergone a mixed experience, frequently dependent upon the caliber of staff available. While annual audits are no longer qualified, the recent delays in the FY2014 audit indicate the problem of limited capacity. In the absence of any long-term planning framework, MTBIF was envisaged as the guiding tool of policy and budgetary resource allocation. However, while the MTBIF was initially compiled as required under the Compact, in recent years it has not been maintained or used as an active tool of management. A system of performance budgeting was implemented with technical assistance supported by the United States, and some departments, Education and Health, prepared performance budgets. However, the rest of the government has not moved to this system, and in no cases is there monitoring or assessment of performance. Financial management information systems provide adequate accounting and audit data, but they do not provide a basis for performance management, fiscal statistics, or budgeting.

148. ***State-Owned Enterprises:*** The SOE sector remains a considerable risk to sound financial management, with subsidies and capital transfers representing 25 percent of domestic government revenues. Efforts to reduce this high level have been made but without success.

149. ***Tax Reform:*** Attempts have been made to reform the outmoded and inefficient tax regime but have not been met with success. A VAT was introduced in the 1990s and almost immediately repealed due to lack of implementation capacity. A tax reform initiative sponsored by the IMF was introduced more recently, but is still awaiting consideration by the Nitijela.

150. ***Private Sector Regulatory Environment:*** Little attention has been devoted to the private sector regulatory environment. No reforms have been considered to improve the regime for private investment. However, despite the lack of an improved enabling regime, significant foreign investment has been attracted in the fisheries sector. The World Bank's "Ease of Doing Business Survey" ranked the RMI 140th out of 189 countries in 2016.

151. Overall, the policy, regulatory, and institutional environment requires additional reforms if the pace of economic development and growth are to accelerate. Despite these limitations, the RMI has achieved a degree of economic growth that would not have been expected for such a remote and resource-scarce nation.

V. USE AND EFFECTIVENESS OF UNITED STATES FINANCIAL ASSISTANCE

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

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

154. The RMI has dedicated 97 percent of its non-infrastructure Compact expenditures to the education (59 percent) and health (38 percent) sectors. The RMI spent significant amounts of Compact funds on personnel in the education and health sectors, which led to a JEMFAC resolution aimed at capping the budgetary levels for personnel in these sector at fiscal year 2011 levels because of concerns about the sustainability of sector budgets as compact funding continues to decline through fiscal year 2023.

155. In Fiscal Years 2004 – 2013 the RMI spent approximately 50 percent, or $215 million of compact funds in the education and health sectors. Most of the compact funds in these sectors paid for personnel costs, leased housing, food and utility bills.

156. An important conclusion of the GAO report was that "because of data reliability issues, [the RMI cannot] demonstrate whether it has made progress toward its goals in [the education and health] sectors." This review, coming on the heels of the GAO report, does not dispute the basic conclusion that data reliability (and validity) issues must be addressed in order to accurately report on the effectiveness of Compact assistance. As such, this review limits its coverage to the use of funds over the 10-year period. Recommendation No. 5 of this review is directly targeted toward addressing the mandate of measuring Compact grant effectiveness.

Table 5.1 RMI operating sector grant annual expenditures (US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
CB		$0.06			$0.17	$0.40	$0.30	$0.30	$0.29
EDU	$10.19	$11.50	$11.62	$12.63	$12.79	$13.93	$13.13	$13.73	$13.53
ENV	$0.33	$0.38	$0.41	$0.20	$0.21	$0.24	$0.21	$0.66	$0.55
HLT	$6.79	$6.95	$7.52	$7.97	$7.72	$9.12	$9.89	$8.54	$8.32
PSD	$0.33	$0.33	$0.35						
	$17.64	**$19.21**	**$19.90**	**$20.80**	**$20.89**	**$23.68**	**$23.53**	**$23.23**	**$22.70**

Notes: Sectors: Capacity-Building (CB), Education (EDU), Environment (ENV), Health (HLT), and Private Sector Development (PSD).

Recommendation No. 6 of this review focuses on improving RMI compliance and accountability in a manner designed to be fully responsive to the GAO's conclusions and recommendations with respect to accountability.

157. The RMI has tracked 20 indicators selected by the RMI Ministry of Education for measuring progress (see appendix XX for a list of RMI's education indicators). The RMI's overarching education goals were to improve the educational system of the country including primary, secondary, and postsecondary education, and to develop the country's human and material resources necessary to deliver these services. The GAO found problems with data reliability in RMI education indicators.

158. The RMI established 26 indicators to measure progress toward its goal of improving primary health care in the RMI in 2006, and tracked them since 2007 (see appendix XX for a list of the RMI's health indicators), according to the RMI's Ministry of Health. The GAO found that 1 of the subset of 5 indicators that were reviewed--tuberculosis prevalence rates--was sufficiently reliable to assess progress in the health sector.

159. Table 5.1 shows the audited expenditures in each of the operating sectors identified in the Amended Compact, while Figure 5.1 shows the trends during the 10 years from FY2004-FY2013. Total expenditures over the period were $213.2 million. This represented 65 percent of the total Compact sector grant spending, with the other $112.8 million (35 percent) having been spent on public sector infrastructure. The trends across sectors are fairly consistent, with expenditures increasing in education through FY2009 and in health through FY2010. The downturn in the latter period is a result of the structure of the Amended Compact, specifically the decrement of sector grant funding by $500,000 annually. It should be noted that one conclusion of the GAO report, that "[the RMI] must complete plans that address annual decrements in Compact funding," remained un-addressed at the end of the period under review but was comprehensively addressed in 2014 through the completion of the Decrement Management Plan and integration into the fiscal planning framework.

160. There is a paradox in the RMI, in which the near total allocation of Compact operating sector grant funds for education and health—consistent with Amended Compact explicit priorities—created a budget and resource allocation challenge, as the effects of the annual decrement accumulated over time. The decrement thus appeared to place immense downward pressure on education and health budget requests, especially in the absence of a coherent policy to offset decrements through increases in local revenue support to those priority sectors. At the time of completion of this review, a reasonable and broadly participatory accommodation has been made through the Decrement Management Plan to commit other local revenue sources to the health and education sectors so that the declining value of Compact grants—while still challenging—should not negatively impact priority spending in education and health.

Table 5.2 RMI sector grant annual unexpended amounts, carryover (US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
CB		$0.04	$0.10		$0.13	$0.03	$0.11		$0.01
EDU	$0.56	$0.57	$0.31	$1.01	$0.33	$0.33	$0.23		$0.10
ENV	$0.07	$0.03	$0.00	$0.01	$0.01		$0.02		$0.01
HLT	$0.10	$0.11	$0.15	$0.36	$0.36	$0.03	$0.42		$0.24
PSD	$0.03	$0.04	$0.01						
	$0.76	**$0.79**	**$0.57**	**$1.39**	**$0.82**	**$0.38**	**$0.78**	**$0.00**	**$0.36**

Notes: Sectors: Capacity-Building (CB), Education (EDU), Environment (ENV), Health (HLT), and Private Sector Development (PSD).

161. Table 5.2 indicates the level of annual grants that remained unexpended at the end of each fiscal year through the period under review. For the RMI, this issue has not been particularly problematic. Under the terms of the Amended Compact, the unexpended funds do not lapse, but they do return to the U.S. Treasury for awards in subsequent years. In general, the programming (or reprogramming) of such carryover funds has been channeled toward nonrecurrent uses, so as to not exacerbate problems related to decrement management.

162. Finally, Table 5.3 indicates the annual expenditure during the period under review of the public infrastructure sector grant component of the Amended Compact. Total spending was relatively consistent over the period, with a modest slowdown in the final two years under review that carried into the subsequent two years, due to identified inadequacies of the RMI's project management capacity.

163. The RMI tracks progress in the infrastructure sector by the completion of projects. The RMI expended $102.5 million dollars on infrastructure projects including infrastructure maintenance, from fiscal years 2004 through 2013. The RMI stated it has constructed or renovated over 200 classroom facilities in the education sector and 45 projects in the health sector and has also conducted essential maintenance at its two hospitals.

164. During fiscal years 2007 through 2013, the RMI's Project Management Unit was generally consistent in reporting monthly to the Office of Insular Affairs on the status of construction activities. The reports included the project number and name as well as a brief description of the project. These reports also included categories such as the contract value, amount certified to date, estimated final cost, percentage completed, and completion date, and other details such project status--completed, on hold, or on-going for example.

165. In August 2012, allegations were raised by an RMI official regarding the Project Management Unit's use of substandard materials and bid rigging. OIA proposed a review by an independent engineering firm in response to the allegations. OIA recommended to the Joint Economic Management and Fiscal Accountability Committee (JEMFAC) at its March 2013 meeting that additional allocations of compact infrastructure funds to the RMI be withheld until

Table 5.3 RMI infrastructure sector grant annual expenditures (US$ millions)

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
INF	$10.10	$10.93	$10.22	$11.99	$12.44	$17.18	$8.90	$11.33	$9.96	$9.71

the review was completed and the results submitted to JEMFAC. The review was submitted to the RMI in May 2014.

166. The school buildings and dispensaries constructed throughout the RMI were built using standard designs prepared by a professional engineering firm. The College of the Marshall Islands Master Plan, initiated in 2007 with capital projects worth over $25 million, was almost completed when we visited in January 2013. Future infrastructure projects include the redevelopment plan for the hospital in Majuro, development of a solid waste disposal site for Majuro, schools within Kwajalein atoll and a water/wastewater system for Ebeye. Various designs for the hospital project, which was estimated to cost between $50 million and $70 million, have been discussed for over 5 years. The key unresolved issue is the size of the new facility, which was still being discussed as of June 2013.

167. The RMI has recently begun to focus on preventive maintenance of infrastructure facilities. For example, in its fiscal year 2013 budget statement for infrastructure, the RMI noted that an adequate level of maintenance resources was critical for the longevity of the new College of the Marshall Islands campus, and RMI proposed allocating $280,000 for this purpose.

VI. THE COMPACT TRUST FUND

168. Under the Amended Compact, a Trust Fund for the people of the RMI was established. The annual decrement in U.S. sector grants amounts is the annual increment to U.S. contributions to the trust fund. Table 6.1 illustrates this payment structure, showing the aggregate structure of the annual Compact grants and the contributions to the CTF. The United States annually contributes to the RMI $57.7 million, partially adjusted for inflation, according to the schedule. The annual sector grants start at a level of $31.9 million in FY2004 but are to be annually decreased by $0.5 million. The difference between the total contribution and the annual sector grant levels will be deposited in the trust fund.

169. Additional support to the RMI's trust fund is provided by Taiwan. Under a memorandum of understanding, Taiwan has agreed to transfer $40 million to the RMI during the period of the Amended Compact.

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

> 7. *The Joint Trust Fund Committee may disburse to the Government of the Republic of the*

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

	Annual Sector Grants	Trust Fund Contribution	Total Contributon	Taiwan contribution "A" account	Taiwan contribution "D" account
FY04	31.9	7.0	57.7	1.00	3.00
FY05	31.4	7.5	57.7	0.75	1.75
FY06	30.9	8.0	57.7	0.75	1.75
FY07	30.4	8.5	57.7	0.75	1.75
FY08	29.9	9.0	57.7	0.75	1.75
FY09	29.4	9.5	57.7	2.4	
FY10	28.9	10.0	57.7	2.4	
FY11	28.4	10.5	57.7	2.4	
FY12	27.9	11.0	57.7	2.4	
FY13	27.4	11.5	57.7	2.4	
FY14	26.9	12.0	62.7	2.4	
FY15	26.4	12.5	62.7	2.4	
FY16	25.9	13.0	62.7	2.4	
FY17	25.4	13.5	62.7	2.4	
FY18	24.9	14.0	62.7	2.4	
FY19	24.4	14.5	62.7	2.4	
FY20	23.9	15.0	62.7	2.4	
FY21	23.4	15.5	62.7	2.4	
FY22	22.9	16.0	62.7	2.4	
FY23	22.4	16.5	62.7	2.4	

Marshall Islands, from the B Account (supplemented from the C Account if the B Account is insufficient):

(a) in Fiscal Year 2024, an amount equal to the Annual Grant Assistance in Fiscal Year 2023, plus Full Inflation; and

(b) beginning in Fiscal Year 2025, and thereafter, an amount of funds no more than the amount equal to the Annual Grant Assistance in Fiscal Year 2023 plus Cumulative Full Inflation thereon, plus any additional amounts for Special Needs approved under paragraph 5(c) above.

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

171. It should be noted that the RMI has funded the "D" account within the CTF mechanism, but the value of that account is not reported in the books and records of the CTF. The value of that account at the end of FY2015 was just under $12 million, or roughly 5.0 percent relative to the size of the CTF at that date. To the extent the RMI makes additional voluntary contributions to the "D" account or a separate fund dedicated to post-FY2023 fiscal sustainability, it could develop an important supplemental funding source to mitigate periodic or sustained fiscal shocks.

172. It should also be noted that, although not required to do so, the RMI has contributed an additional $2.85 million in voluntary contributions to the CTF since 2015.

173. During the period that the CTF has been invested since the outset of FY2006, the CTF has achieved an asset-weighted annual rate of return of 4.9 percent.

B Trust Fund Analyses

174. Two recent studies of the Amended Compact Trust Funds in the FSM and RMI[13] both deploy Monte Carlo simulation analysis to investigate the likely performance of the two Trust Funds. According to both studies, there is a significant risk of a zero distribution year in which no money is available for the people of the RMI because of the structure of the fund and the distribution framework.

175. Figure 6.1 provides a depiction of the simulated CTF at the end of FY2023 before distributions commence. It indicates that from a current value at the end of FY2015 of $247 million the fund is likely to attain a value of $637 million in FY2023 (the median simulated value). While the median value is above the size the fund would need to be to provide the maximum allowable distribution in a given year, the probability of attaining such an amount is 70 percent. Further it must be born in mind that this level is only a benchmark and is based on a risk-free assumption of market returns.

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

176. There are several independent reports and studies from the Government Accountability Office, the Asian Development Bank, and the Graduate School USA which analyze the Trust Funds and discuss the adoption of alternative rules to govern the Trust Fund and distributions from the Trust Fund. These reports identify potential problems in the design of the CTF framework for implementation during the distribution period that make it difficult to operate administratively. These reports make several recommendations for amendments to the Trust Fund Agreement to address these challenges. The United States and the RMI are working to identify ways for both Parties to achieve the objective of the Trust Fund and plan to consult on strategies for implementing any agreed upon changes.

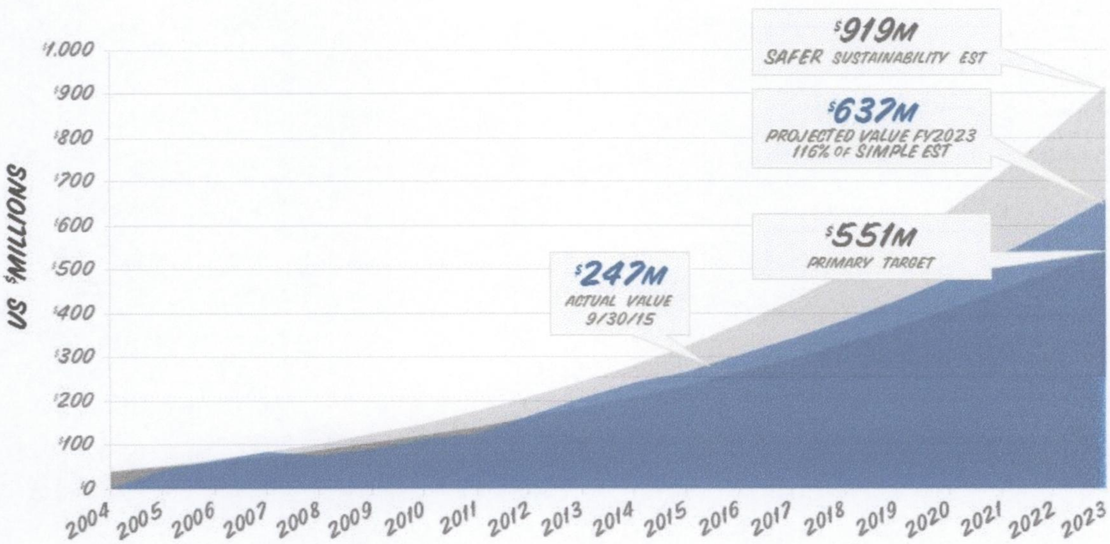


Figure 6.1 Primary target, projected value and SAFER estimate through FY2023

VII. Recommendations

1. Making Compact Assistance More Effective

177. While we have robust macroeconomic data which informs decisions and provides some insight into the effectiveness of U.S. assistance, as noted by the U.S. Government Accountability Office (GAO), the RMI has not developed adequate data and reporting systems to be able to demonstrate progress in the health and education sectors, where the bulk of Amended Compact funding has been expended. During the reporting period, there has been limited progress on increasing or initiating monitoring programs, including to record either results (outcomes) or deliverables (outputs). There is a need to ensure that health and education statistics and performance monitoring can be reliably used to inform monitoring, in the short term, by U.S. grant managers and to inform JEMFAC decision-making regarding the effective use of Compact Sector Funding and, in the long term, by the GRMI itself once U.S. direct assistance to these sectors ends post FY2023. JEMFAC could be made a more effective body by enacting the recommendation described below.

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

178. ***Compact Trust Fund Level:*** Both Parties have expressed concern that the funding level likely to be achieved may not be sufficient to meet the needs of both Parties. The Trust Fund would benefit from actions by the original Parties to supplement the Trust Fund from all sources, including from other states Subsequent Contributors as well as from appropriations for compensation under Section 111(d) of the original Compact, or successor provisions under the Amended Compact Act, involving the tax and trade provisions of the original Compact. With the current framework provided for by the Trust Fund Agreement, external analyses have found a significant probably of a year in which no funds would be available for distribution. Some technical amendments may be desirable to better meet the objectives of the Original Parties after FY2023, and both Parties should consult on their respective objectives for the Trust Fund and the most appropriate path to achieving them.

- Recommendation No.2: Secure additional funding from the RMI; seek additional funding from other donors and other sources; assess the possibility of contributing unallocated (carry-over) sector grant funds into the Trust Funds; and

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

2. Federal Programs

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

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

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

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

- Recommendation No. 5—Amend the FPA so that:
    - The due date for the section 215 Annual Economic Report as specified in Article V(1)(d) should be changed from February of each year to the end of July each year. The current timeline is difficult to achieve, given the desire to use audited figures, other reporting requirements, and limited capacity.
    - The due date for the annual single audit as specified in Article VIII should be changed to be consistent with the federal Single Audit Act.
    - FPA Article VI, section 2, Program Monitoring, Performance Reports, and Records Retention, should be changed to specify that the fourth quarter report format covers the full fiscal year, and the due date should be changed from 30 days to 60 days after the end of the fiscal year.

4. Tax and Trade

181. The Compact Act of 1986 provided for potential compensation to the RMI of up to $20 million, with the possibility for $40 million more, if the government of the RMI could demonstrate adverse impacts on its finances and economy as a result of unilateral changes the U.S. Congress made to the tax and trade provisions in Title II of the original Compact. The Amended Compact Act of 2003 referred to that provision and carried it forward in section 108(b). In 2009, to evaluate the RMI's claim, the Department of State reconvened the Interagency Group (IAG) Congress had requested be convened after the RMI's first petition in 1991. The IAG concluded that the RMI had reasonably demonstrated net adverse impacts, offset by the value of additional U.S. federal programs and services provided, based on the loss of Title II benefits in making their request for $20 million in further compensation under Section 111 (d) of the Compact Act. Per the terms of the Amended Compact, the $20 million would be

deposited into the Compact Trust Fund. In 2010, the Department notified Congress of the IAG findings. However, funds have not been appropriated to make such a payment.

-

Government of the Republic of the Marshall Islands
Comments and Recommendations

Ten Year Review of the Compact of Free Association, as Amended

Prepared by:
Office of Compact Implementation
Ministry of Foreign Affairs

8 January 2018

INTRODUCTION

Section 104(H)(2) of US Public Law 108-188 provides:

During the year of the fifth, tenth, and fifteenth anniversaries of the date of enactment of this resolution, the Government of the United States shall review the terms of the respective Compacts and consider the overall nature and development of the U.S.-FSM and U.S.-RMI relationships including the topics set forth in subparagraphs (A) through (E) of paragraph (1). In conducting the reviews, the Government of the United States shall consider the operating requirements of the Government of the Federated States of Micronesia and the Government of the Republic of the Marshall Islands and their progress in meeting the development objectives set forth in their respective development plans. The President shall include in the annual reports to Congress for the years following the reviews the comments of the Government of the Federated States of Micronesia and the Government of the Republic of the Marshall Islands on the topics described in this paragraph, the President's response to the comments, the findings resulting from the reviews, and any recommendations for actions to respond to such findings.

Many of the RMI Recommendations are similar or identical to those made in the first 5-year review in 2011, which unfortunately did not result in any action. In general, however, the RMI is pleased to note that the U.S. is making important and substantive recommendations in the Second Five Year Review which can provide a basis for substantive discussions and changes to improve the Compact, particularly with respect to the Trust Fund as we approach the time when it will be expected to produce income for distribution to the RMI Government for the agreed Compact Sectors.

As a result, among the changes in the RMI Government's position for the Second Five Year Review is foregoing its recommendation to reduce the decrement (Five-Year Review) given its desire to improve the viability of the Trust Fund. It should be further noted that the chronological order of these recommendations do not, in any way, relegate their priority.

RECOMMENDATIONS

1) Technical Amendments to the Trust Fund Agreement (TFA)

Since the effectuation of the amended Compact, questions have been raised as to the viability of the Trust Fund either with the level of disbursement allowed in the TFA or if there would be any disbursement at all. The General Accountability Office, a DOI-funded FY08 Economic Review and the RMI Government have all raised concerns related to the inadequacy of the Trust Fund post-2023, and the very real possibility of zero distribution years in the future.

The Trust Fund rules for Account C does not allow revolving amount to exceed three times the amount of Fiscal Year 2023 allocation in real terms after 2023. Should the corpus earn income over the 6%, that excess will be able to replenish Account C allowing and enabling for a budget allocation. However, with poor performance and no income earned, the possibility of Account C not holding sufficient funds is high. Even with income earned at up to 6%, Account A will still not be able to provide funding for annual budgets.

a. In general, the RMI Government further recommends that Section 101(d) of Public Law 108-188 should be amended to allow the RMI and U.S. Governments to agree on any amendments to the Trust Fund Agreement without enactment by Congress. This would facilitate timely action by the TFC in fulfillment of their fiduciary duties.

b. Provide measures, as soon as possible, for ways in which the Trust Fund can better meet the needs and objectives of providing reliable sustainable and robust source of income including the elimination of the likelihood of a zero-distribution year, of the Parties *including potential Amendments to the Trust Fund Agreement*.

c. Annual Grant Assistance should continue for an additional 3 years before Trust Fund income is utilized based on the fact that the Trust Fund has not been invested for 20 years, as provided in the Trust Fund Agreement, and was only fully invested in accordance with the TFA in late 2006.

d. The United States should keep its commitment to the RMI under the Compact and appropriate funds to make the contribution provided in Section 216 (b) of the Compact and Section 108 (b) of the United States Compact Act.

e. The RMI and US Governments have a fiduciary obligation under the TFA to attract subsequent contributors and need to make adjustments to the TFA conducive to attracting additional subsequent contributors in furtherance of these efforts. The RMI can continue to make additional contributions based on available funding based on US making the Section 216(b) contribution and taking positive steps toward bringing in other contributors.

2) *Technical Amendments to the Fiscal Procedures Agreement*

The amended Compact's annual grant assistance and the Supplemental Education Grant are subject to the reporting and accountability provisions of the Fiscal Procedures Agreement (FPA). The FPA was structured to assist implementation for both the RMI and U.S. governments with the purpose of providing "procedures that are most efficient, economical, and beneficial to the discharge of the obligations and responsibilities of each government and which each party agrees to implement and abide by".

RMI Government applied the FPA requirements since Compact Implementation in FY04. The RMI Government had prepared a Medium-Term Budget and Investment Framework (MTBIF), which was utilized every fiscal year to help estimate and guide Compact annual economic grant assistance along with the creation of annual Sector Portfolios for Compact Fund recipient ministries and agencies, such as health, education, and environment. In 2011, the RMI Government submitted a decrement plan and subsequently a Financial Management model in 2014, which is consistent with the aim and intend of MTBIF to predict long term implications of fiscal policies on the budget; explore the mix of policies that will provide the desired impact on the budget; explain the likely effects of policy decisions; and provide a policy and budgeting tool.

During the same year in 2014, the RMI Government created a more comprehensive decrement management plan to address decreases in compact financial assistance and to include issues outline in JEMFAC Resolution 2010-1. The approaches to addressing the decrement challenge were expenditure cutting and raise of revenue. For expenditure cutting, ministries were asked to identify the lowest priorities to meet the 15% cut, and since expenditure cutting was not sufficient, other alternative measures were taken which included tax reform, reduction in subsidies to State Owned Enterprises (SOEs) and utility payments to Majuro Landowners, and increase use of fishing fees (Marshall Islands Marine Resources' funds).

As an update to the Decrement Management Plan, the RMI Government has demonstrated its commitment to the plan by applying a 3% cut in the FY15 budget, and reforms for tax and SOE are forthcoming in the parliament.

The RMI Government believes that the FPA should be adjusted to address a number of issues including the number and timing of reports required there under. The following is a preliminary list of said adjustments.

a) The Section 215 Annual Economic Report as indicated in the FPA's Article V (1) (d) is due in February of each year. The timeline is difficult to achieve given other reporting requirements and limited capacities. It is suggested that the timeline be extended to end of July.

b) FPA Article VI, Section 2 Program Monitoring, Performance Reports and Records Retention: That Quarterly Sector Grant Performance Reports be changed so that the 4th quarter report format is adjusted so it also reports on annual Fiscal Year activity and due 60 days after the reporting period.

c) FPA Article 8 Audit. Currently the Single Audit conducted annually is required to be made available to the USG by the beginning of the third fiscal quarter following the end of the Fiscal Year under review (April). The RMI's Single Audit is not completed until 30 June given the audit schedule and time for the RMI to review the audit draft. It is suggested that the audit be submitted by July 1 for the preceding Fiscal Year.

While the RMI has been working to comply with the FPA, the Department of Interior Office of Insular Affairs (OIA) has been applying extraneous and non-applicable rules to the Compact Sector Grants as if they were subject to rules and regulations applicable to federal grants in the U.S. states. This was not agreed to in the Compact and FPA and causes a situation where RMI staff responsible for Compact funding can never be certain of what rules are being applied.

Discussions regarding the above should commence with the membership of the Joint Economic Management Fiscal and Accountability Committee (JEMFAC). Discussions should also start on ways to improve JEMFAC operations insofar as decision-making on Compact funding is concerned, and come to terms with applicable rules and procedures through more collaboration and equal partnership, Compact funding will be prioritized based on RMI's overall policies and long-term goals.

3) Making the Supplemental Education Grant (SEG) a Permanent Appropriation, Providing the Full Amount of $6.1 million and applying the Required Inflation Adjustment

Section 105 Supplemental Provisions, (f)(B)(iii), of Public Law 108-188, allows for the provision of the annual SEG in lieu of eligibility for formerly provided education programs. These programs included those under Title I of the Elementary and Secondary Education Act of 1965, Title I of the Workforce Investment Act of 1998 (other than subtitle C or Job Corps), Title II of the Workforce Investment Act of 1998, Title I of the Carl D. Perkins Vocational and Technical Education Act, the Head Start Act and parts of the Higher Education Act of1965.

The SEG was authorized to be appropriated by the U.S. Secretary of Education to supplement the education grants under section 211(a)(1) in the amount of $6.1 million as of FY05 and inflation adjusted as of FY05 per Section 218 of the Compact to 2023.[1] The funds are administered through the U.S.-RMI Joint Economic Management and Fiscal Accountability Committee and the accountability measures of the FPA.

The funds are not permanently appropriated and must be requested on a year-to-year basis during the U.S. budget process.

As of FY15, the RMI has not received the annual allocations of $6.1 million with inflation adjustments, as reflected in the table below:

[1] Section 218-Inflation Adjustment allows for Compact grant and Trust Fund contributions to be adjusted for each U.S. fiscal year by the percent that equals two-thirds of the perfect change in the United States Gross Domestic Product Implicit Price Deflator, or 5 percent, whichever is less in any year, using the beginning of Fiscal Year 2004.

Fiscal Years	**2005**	**2006**	**2007**	**2008**	**2009**
SEG Grant	$6,100,000	$5,941,769	$5,990,490	$5,895,668	$5,886,017
Fiscal Years	**2010**	**2011**	**2012**	**2013**	**2014**
SEG Grant	$5,895,667	$5,885,052	$5,867,006	$5,557,490	$5,560,767

The transition year of 2004 left some programs underfunded and confusion was experienced about when grant funds would be received. Such circumstances and requirements have hindered sector and specific program planning and monitoring especially in the first few transition years. For instance, for FY09 the Ministry of Education was using FY08 funds appropriated by the U.S. Congress.

In this regard, the RMI Government recommends the implementation of the SEG requirement by making it a permanent appropriation and providing the full $6.1 million with the necessary adjustment in inflation.

4) Renewing the Federal Programs and Services Agreement and Extending Federal Programs Provided in US PL 108-188.

Section 221 of the Compact provides the authority for several federal programs and services to be made available to the RMI by way of a separate agreement, the Federal Programs and Services Agreement (FPSA). These programs and services include U.S. Postal Services; the United States Weather Service; the U.S. Federal Aviation Administration; the U.S. Department of Transportation (Economic Authority); and U.S. Disaster Assistance. These programs were renewed in 2003 for 20 years and will expire at the end of FY 2023 unless action is taken. All of the foregoing federal services provide essential assistance to the RMI and cannot be replaced in terms of the economies of scale by a small island nation like the RMI.

The U.S. Compact of Free Association Amendments Act of 2003 (U.S. Public Law 108-188) also extended several important federal programs (in addition to creating the Supplemental Education Grant discussed above). Notably, Section 105(1)(B)(i) and (ii) provide for continuing Special Education programs and Pell Grants to continue in the RMI through FY 2023. In the case of the Pell Grants, the College of the Marshall Islands (CMI) and land grant institution relies almost entirely on the availability of Pell Grants for their programs and operations.

5) Restoring the Ebeye Post Office

The United States Postal Service (USPS) has terminated delivery of mail to the Ebeye Post Office on the basis that it is not an "exchange office" under the Postal Services Agreement to the Federal Programs and Services Agreement (FPSA) to the Compact. This is despite the fact that the Postal Services Agreement anticipates that more than one exchange office may be designated by the RMI (currently Majuro). Ebeye has always been a separate postal facility with a separate zip code, and will continue to be a separate facility given the long-term relationship under the Military Use and Operating Rights Agreement (MUORA). In other words, the residents of Ebeye are hired to work at the Ronald Reagan Ballistic Missile Defense Test Site and will continue to reside on Ebeye for the duration of their employment. Termination of mail delivery to Ebeye does not only affect the Ebeye residents directly but the Ronald Reagan Ballistic Missile Defense Test Site indirectly as well. Additionally, there is a community of Marshallese who work on Roi-Namur, which is an extended zone of United States Army Garrison-Kwajalein Atoll (USAG-KA). *Mail delivery will have an impact on both communities.*

The RMI Government recommends that the Postal Services Agreement should be amended to clarify that Ebeye is an exchange point, and that mail should continue to be delivered to Ebeye.

6) U.S. Imports into the RMI (Most Favored Nation Clause)

Section 244(a) of the amended Compact provides that "All products of the United States imported into the Republic of the Marshall Islands shall receive treatment no less favorable than that accorded like products of any foreign country with respect to customs duties or charges of a similar nature and with respect to laws and regulations relating to importation, exportation, taxation, sale, distribution, storage or use".

Needless to say, the above provision puts the RMI at a disadvantage in relation to negotiating Free Trade Agreements with other developed countries. In short, Section 244(a) states that if the RMI provides better treatment of imports of other developed countries that the status quo provided to the U.S. now, this treatment will automatically apply to the U.S. As a small island developing state, the RMI will lose twice: first to the other developed country, and second to the U.S. with respect to this "free rider" application.

In order for the RMI to fully explore other developed countries markets and diversify its exports markets, a waiver by the U.S. Government is necessary. Providing RMI with this flexibility under the amended Compact will enable RMI to explore new markets and also develop its sectors, which necessitates the waiver of Section 244(a). This waiver is implicit in Section 244(c) of the amended Compact as follows:

"Prior to entering into consultations on, or concluding, a free trade agreement with governments not listed in Article 26 of PICTA, the Republic of the Marshall Islands shall consult with the United States regarding whether or how subsection (a) of section 244 shall be applied."

7) RMI Access to the U.S. Market

Despite the fact that U.S. has granted RMI duty free and quota free access for some products, i.e. zero import duties, it has not provided the RMI with duty free access on key products. Under the amended Compact, 0% tariff is provided for fresh or frozen tuna and fresh or frozen tuna fillets. However, for canned tuna there is a duty of 6-12% for canned tuna in water and 35% for canned tuna in oil. Furthermore, the Rules of Origin (ROO) requirement for exporting into the U.S. is 35% out of which about 15% of the value of materials has to be from the U.S.

RMI requests that U.S. provides 0% duty on canned tuna both in water and in oil. This will enable RMI to develop its canneries and thus create more jobs and also attract foreign direct investment. This will also have value addition to RMI's fisheries products. In addition to this, RMI requests flexible rules of origin of 35% without any conditions on where we source the materials from, meaning that is it can be from U.S. or any other country (the 15%). We note that under the Generalized System of Preference, U.S. is already providing duty free access on these products to other countries. Given the special and unique relationship envisioned under the amended Compact, RMI needs the same.

8) Addressing the Inflation Adjustment

The amended Compact provides for a package of annual grant assistance as described in Section 211. The grant assistance is to assist in the development of the RMI economy and benefit its people by improving living standards. The grant funding has been crucial for the RMI to provide basic services, such as in health, education and infrastructure development.

The grant assistance was negotiated by the RMI with the aim to achieve fiscal stability during Fiscal Years (FY) 2004-2023. However, given that the U.S. Government only allows a partial inflation adjustment on top of a decrement to the grant assistance of $500,000 per year, fiscal stability has not been achieved. This is even despite increased domestic revenue generation of16.4 percent from FY04-FY08, reducing or limiting general fund expenditures (except for education, health and infrastructure), receiving supplemental funds from the Republic of China (Taiwan), and increasing other revenues such as from the RMI Ship Registry. *Thus, it is becoming imperative that the Compact funding is fully inflation adjusted annually and add the extra 1/3 adjustment from FY04-17 as lump sum into the Trust Fund.*

For FY04-17, the RMI Government has undergone fiscal adjustments to respond to the limited growth of budget resources. As previously stated, a decrement management plan is now in place, identifying possible expenditure cuts within government line ministries and agencies. At the same time, it identifies revenue raising efforts to be directed to the priority areas of the government. In FY2014, the RMI Government completed its Medium Term National Strategic Plan identifying priorities of the government. The RMI Government continues to expand the use of performance based management system within all ministries and agencies. In FY2015, RMI implemented the decrement plan by applying a 3%, in expenditures, across the board. Efforts to push forward with the SOE and Tax Reform bills are still ongoing. However, in the event the bills are not successful, the government is still dedicated to implementing the decrement management plan. It should also be highlighted that the RMI Government has decided not to include its previous recommendation for reducing the decrement.

Due to the foregoing, support should be given to amending Section 218 so that a full inflation adjustment is applied to Title Two and the SEG. Compact funding should maintain a "real" value. Otherwise, RMI is facing not only the loss from the decrement but also the real inflationary loss. The extra 1/3rd adjustment from FY04-17 will be added as a lump sum into the Trust Fund Accumulated U.S. Trust Fund Contributions to be provided Upfront.

Another consideration for a substantive influx of funds into the Trust Fund is for the U.S. Government to providing its remaining annual contributions to the Trust Fund in 2018. In other words, rather than providing these contributions each year, they can be added into the Trust Fund in one year. The RMI has proposed a similar arrangement with Republic of China (Taiwan) to front-end load their contributions to the Trust Fund.

As with the abovementioned Tax and Trade Compensation, the RMI is of the view that the money available now, as opposed to later, is worth more in terms of its earning potential. As it is in the interest for both the governments of RMI and U.S. to ensure a smooth transition post-2023, all funds and fund sources must be evaluated and considered.

10) Additional RMI Contributions to the Trust Fund

The RMI made additional contributions to the Trust Fund in FY16 and plans on continuing to do so until 2023. These contributions are beyond what is required by the terms of the Trust Fund Agreement and amended Compact because the RMI understands that if the status quo remains unchanged, the Trust Fund will not achieve its purposes in the future. The RMI also notes that these investments are being made despite the other urgent needs and strains on the RMI General Fund. The RMI has proposed a similar arrangement with ROC (Taiwan) to continue their contributions beyond 2023.

11) Restoring National School Lunch Program Eligibility for the RMI

The RMI was eligible and participated in the USDA school lunch program during the term of the original Compact, although that eligibility ceased prior to the effective date of the amended Compact. Thus, eligibility for the USDA National School lunch program was not included in the cash out of federal programs that resulted in the SEG under the Compact, as amended.

The amended Compact makes education a priority for the RMI, and the RMI has maintained its commitment to increase funding in the education sector, and in particular primary education despite competing demands for these resources.

During the first couple years of the amended Compact and despite higher enrollments, the RMI Ministry of Education (MOE) noticed high truancy rates among the elementary student population, particularly in the afternoon class sessions. This was directly due to the fact that there was no school lunch program in place, and students were not receiving even minimum nutrition while attending class. The result was that students would leave school after the morning session, and not return.

Recognizing the fact that the public schools needed to provide essential nutrition and sustenance to its student population, MOE first launched the Majuro School Lunch Program in Fiscal Year 2006 with financial support made available from the 2005 SEG. The goal of MOE in starting the school lunch was to deal with the truancy problem in the public-school system in order to increase attendance so as to improve the overall learning outcome of students. A recent UNICEF study estimated/showed that 35% of RMI children are stunted having higher risks of poor cognitive and educational achievement in life. The government is committed to improving Early Childhood development hence the reason for its request for US's consideration for Feeding Program eligibility.

For FY11, the JEMFAC approved an allocation of Compact funding FY11, but also made clear that this would be the last year that Compact funding would be made available for the school lunch program in Majuro. The combination of other compelling demands on Compact grant assistance, SEG, and local resources makes it difficult, if not impossible to sustain a viable school lunch program for Majuro public schoolchildren.

This fact threatens the RMI's ability to achieve the mutually agreed objective of providing better outcomes in its education system in the future. If children are not provided essential nourishment and nutrition while attending school, RMI's desire to improve the education of its people will be jeopardized. A substantial amount of Compact funding has been spent on infrastructure for education, and said funding will continue to be dedicated to building new buildings and maintaining old ones. Moreover, MOE has committed time and resources to certify and therefore upgrade its teachers. Given the link between the lack of a school lunch program and high truancy rates, these investments will not count if there are no students in the classrooms.

Restoration of eligibility for the U.S. National School Lunch program will resolve this situation, and allow Compact, General Fund, and SEG resources for education to be more focused on education purposes, while providing the foundation and environment that is conducive to learning in all RMI public schools.

12) RMI Response to US Recommendations

As noted in the Introduction, the RMI believes that the US recommendations provide the basis for way forward on many of the issues raised by the RMI over the past 10 years. Accordingly, we provide our response to the U.S. Recommendations as follows:

U.S. Recommendation No. 1: At this time, the United States should continue funding support for maintenance of economic performance reporting for the RMI, and encourage the RMI to fund development and maintenance of reliable and verifiable health and education sector data and performance reporting systems. Some funds from the Special Education Grant could be used in the education sector for these purposes. JEMFAC should consider allocating Compact sector funds in the health sector for these same purposes.

The RMI concurs with the goals of this recommendation and notes some of these measures with respect to health and education are currently underway and are being reported through the JEMFAC process. The RMI realizes the importance of compiling and maintaining reliable health and education statistics as we work with our development partners.

The RMI also believes that there is an equal need to develop and maintain national economic statistics through strengthening the Economic Policy, Planning and Statistics Office, (EPPSO) in the RMI. Currently, most of economic statistics work is being done by outside consultants. The RMI believes that this aspect of economic performance reporting needs to be strengthened in conjunction with health and education sector performance reporting.

U.S. Recommendation No.2: Secure additional funding from the RMI; seek additional funding from other donors and other sources; assess the possibility of contributing unallocated (carry-over) sector grant funds into the Trust Funds; and

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

The RMI concurs with Recommendation No. 2 insofar as the RMI is able to commit additional contributions, and the TFA requirement that the RMI and U.S. seek other contributors. The RMI notes that it brought Taiwan as a subsequent contributor to the Trust Fund in 2005, but there has been no other contributor since that time. The U.S. and RMI should specifically seek Trust Fund contributions post 2023 which will greatly assist in maintaining a sustainable distribution to the RMI in the future.

RMI is willing to consider disposition of carryover funds to the Trust Fund, but believe that commitments in this regard are premature given the sector needs of the RMI which may be better determined closer to 2023.

RMI fully supports the recommendation in U.S. Recommendation No. 3 as the possibility of a zero distribution in the future appears to be a major structural flaw in the TFA that will likely require amending the TFA.

RMI would further note that discussions should also start with respect to the accountability provisions of the TFA Article 16(10)(a)(1) which is required before any distributions can take place.

U.S. Recommendation No. 4: After the United States clarifies the status of U.S. federal programs, assistance, and services currently provided in the RMI, the United States should work with the RMI to appropriately assess which programs and services must be, should be, and/or would like to be continued after FY2023.

RMI fully supports this recommendation and believes that these discussions need to start as soon as possible.

<u>U.S. Recommendation No. 5</u>—Amend the FPA so that:
The due date for the section 215 Annual Economic Report as specified in Article V(1)(d) should be changed from February of each year to the end of July each year. The current timeline is difficult to achieve, given the desire to use audited figures, other reporting requirements, and limited capacity.

The due date for the annual single audit as specified in Article VIII should be changed to be consistent with the federal Single Audit Act.

FPA Article VI, section 2, Program Monitoring, Performance Reports, and Records Retention, should be changed to specify that the fourth quarter report format covers the full fiscal year, and the due date should be changed from 30 days to 60 days after the end of the fiscal year.

The RMI fully concurs with this recommendation, and notes that these changes would not require Congressional enactment under US PL 108-188.

RMI also believes that discussions need to take place to clarify the situation regarding other extraneous rules and regulations outside of the FPA that are being applied by the U.S. Department of Interior OIA.

<u>U.S. Recommendation No. 6</u>—The Administration encourages Congress to appropriate the $20 million for compensation under Section 111 (d) to be deposited into the Trust Fund for the People of the Marshall Islands.

The RMI fully concurs with this recommendation which it views as a U.S. commitment in the Compact. The U.S. Interagency Advisory Group determined over seven year ago that at least $20 million was owed to the RMI as a result of Section 111(d) of PL 99-239, and further provided in Section 108(b) of PL 108-188. RMI looks forward to working with the U.S. Administration on this important issue.

Other Comments on the U.S. Report

II. Political and Social Context:

46. The RMI is not a party to the 2000 TIP Protocol. As noted in the State Department 2016 Trafficking in Persons Report, the Government of the Republic of the Marshall Islands does not fully meet the minimum standards for the elimination of trafficking and is not making significant *efforts to do so. The RMI remains on tier 3 for the 2016 reporting period.*

Although RMI is not yet a party to the 2000 TIP Protocol, the RMI has taken significant steps eliminate all forms of modern day slavery – trafficking in persons. The latest TIP Report by the US. State Department has upgraded RMI to Tier 2 Watch List after significant efforts have been made during the reporting period. As stated in the TIP Report, the Government has made key achievements including drafting and the passing of the new Prohibition of Trafficking in Persons Act 2017, approval of the National Action Plan to combat trafficking in persons, initiated investigations into allegations of labor trafficking and assisted in the protection and repatriation of foreign labor trafficking. RMI continues to work towards achieving the elimination of trafficking in persons.

III. Review of Economic Conditions & IV. Policy Reform

Chapter 3 and 4, due to the delay of the preparation of the report, a number of fiscal economic reform discussions on these chapters are not up to date. In general, economic and fiscal conditions have improved notably in recent years and the government is revisiting a number of reforms, including strengthening the medium-term budgeting process and other public financial reforms. The Asian Development Bank and World Bank are key partners in these efforts.

Recommendations for Outstanding Issues on Nuclear Issues

1) Respond to the RMI Changed Circumstances Petition

The RMI Government lodged a Petition to Address Changed Circumstances as provided in the Section 177 Agreement in September, 2000. To date, there has not been a response and many of the issues referred to in the Petition continue to adversely impact the Marshallese people. The RMI asks to work with Congress to address the outstanding needs of the Marshallese people.
In conjunction with this recommendation, or in the alternative, the RMI recommends the following measures:

2) Increased Funding for Section 177 Healthcare

Nuclear related healthcare needs to be recognized and addressed through appropriate measures considering the fact that only $2 million was provided annually for the first 15 years of the Compact without any inflation adjustment for these purposes. Since that time, annual appropriations of up to $1 million has been made to address outer-island dispensary needs.

In 2007, legislation was introduced in the U.S. Senate called the "Republic of the Marshall Islands Supplemental Nuclear Compensation Act (S 1756). This bill would have provided for a "Supplemental Health Care Grant" in the annual amount of $4.5 million, on a permanent appropriation basis and adjusted for inflation like other amounts available under the Compact through 2023, to be made available in accordance with the Fiscal Procedures Agreement.

The purposes of the Supplemental Health Care Grant would also have been expanded: (1) to provide Enewetak, Bikini, Ailuk, Rongelap, Utrik, Likiep, Mejit,Wotho, and Wotje, with enhanced primary healthcare with an emphasis on providing regular screenings for radiogenic illnesses by upgrading existing facilities, or by providing quarterly medical field team visits; (2) to improve the capabilities of the RMI to provide secondary treatment for radiogenic illnesses; and (3) to construct and operate a whole body counting facility on Utrik.

The U.S. should introduce and pass legislation similar to S 1756 to address the ongoing healthcare needs of the Marshallese people caused by the U.S. Nuclear Testing Program.

3) Funding to provide for a replenishment of funding for the Marshall Islands Nuclear Claims Trust Fund

The RMI requests that due consideration be given to payment of unfunded Nuclear Claims Tribunal Awards as provided in the Changed Circumstances Petition lodged with the U.S. Congress in September, 2000.

At the time the Agreement for the Implementation of Section 177 of the Compact was signed in June 1983, it was the expectation of the parties that "The Fund" would produce "average annual proceeds of at least $18 million" in order "to provide, in perpetuity, a means to address past, present and future consequences of the Nuclear Testing Program." [Article I, Section 2] Had that been the case, the Fund would have produced more than $240 million during the period since the distributions specified by the Agreement were completed in 2001.

As calculated by the U. S. General Accounting Office (see GAO/NSIAD-92-229), the Fund would have had to generate a 12.5-percent annual return on investment in order to produce the required $18 million per year in distributions. The Fund rarely attained that level of return and, as provided for in Article II, Section 7(a), disbursements from the Fund itself were routinely made in order to meet the required distributions. As a result of those disbursements, the balance of the Fund stood at less than one-third of its original $150 million capitalization by the 15th anniversary of the Compact in 2001. Between that time and the exhaustion of the Fund less than 10 years later, it is estimated that no more than $25 million in "annual proceeds" were produced.

The RMI requests a lump-sum payment in the amount of at $215 million, representing the shortfall in annual proceeds expected to be available for distribution under the Agreement since 2001. As a minimum alternative, the RMI believes that it is entitled to a lump-sum payment in the amount of $105 million, plus interest, representing the difference between the original $150 million value of the Fund that was intended to remain, in perpetuity, and its balance at the time that all of the minimum required distributions were made.

4) Revisions to the Section 177 Agreement Agreed Minutes

The Agreement for the Implementation of Section 177 of the Compact was concluded in June 1983 and represented the final step in the basic negotiation process that led to the new political status of Free Association for the RMI. In addition to the grossly unjust and manifestly inadequate nature of the settlement terms which it contained, the Section 177 Agreement includes certain provisions which have clearly outlived their relevance.

From the perspective of the RMI, the limits on distributions from the four atoll Trust Funds imposed by the Agreed Minutes made part of the 177 Agreement prevent those atolls from managing their funds in a manner appropriate to the needs of their respective communities. Those limits (minimum reinvestment of 30% of income earned and maximum invasion of corpus in the amount of 3% no more frequently than every three years) might be tolerable if the trusts were routinely earning the 12.5% annual rate of return which the Agreement anticipated for the overall Section 177 Fund but that has never really been the case.

From the perspective of the U.S., the fact that the Nuclear Claims Tribunal is no longer in operation raises the need for a different institution or authority to be responsible for ensuring accountability for distributions made from those Trust Funds. That need was identified in a letter dated June 19, 2012, from the Chairman and Ranking Member of the Senate Committee on Energy and Natural Resources to the Secretaries of State and of the Interior asking them "to seek revisions to the 177 Agreement."

Article XIII, Section 4 provides that "This Agreement may be amended at any time by mutual consent of the Government of the United States and the Government of the Marshall Islands."