United States Government Accountability Office

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Report to Congressional Committees

June 2006

COMPACTS OF FREE ASSOCIATION

Development Prospects Remain Limited for Micronesia and Marshall Islands

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Highlights

Highlights of GAO-06-590, a report to congressional committees

June 2006

COMPACTS OF FREE ASSOCIATION

Development Prospects Remain Limited for Micronesia and Marshall Islands

Why GAO Did This Study

In 1987, the United States began providing economic aid to the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) through a Compact of Free Association. In 2004, through amended compacts with the FSM and the RMI, the United States committed to provide more than $3.5 billion until 2023. Joint U.S-FSM and U.S.-RMI compact management committees are required, among other things, to monitor progress toward specified development goals and address implementation of policy reforms to stimulate investment. The legislation implementing the amended compacts (P.L. 108-188) requires that GAO periodically report on political, social, and economic conditions in the FSM and the RMI. In compliance with this requirement, GAO examined each country's (1) political and social environment, (2) economic environment, and (3) status of economic policy reforms.

What GAO Recommends

GAO recommends that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the compact management committees, to ensure they meet requirements to address the lack of FSM and RMI progress in implementing reforms to increase investment and tax income. Interior, Health and Human Services, the FSM and the RMI generally agreed with the recommendation and the need to find development opportunities.

www.gao.gov/cgi-bin/getrpt?GAO-06-590.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David B. Gootnick at (202) 512-3149 or gootnickd@gao.gov.

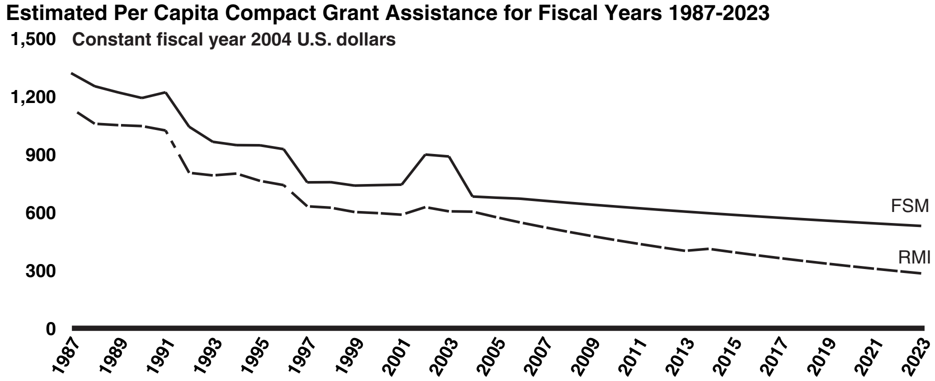
What GAO Found

FSM and RMI political and social conditions challenge, respectively, effective compact grant implementation and health and education progress. Regarding political conditions, for example, the FSM states and national government have been unable to agree on implementation of the compact infrastructure grant, while the RMI government has had difficulty securing agreement from land owners regarding its use of leased land for compact-related projects. Social challenges in both countries include persistent health and education problems despite substantial expenditures. For instance, the FSM and the RMI have low immunization rates relative to other countries with similar income levels.

The FSM and the RMI economies show limited potential for achieving long-term development objectives. Both economies depend on public sector expenditures—funded largely by external assistance—and government budgets have growing wage expenditures, heightening the negative fiscal impacts they will face as compact grants decline (see figure). As a result, long-term economic growth must come from the private sector and increased income sent home from FSM and RMI emigrants ("remittances"). However, poor business environments hamper private industry in both countries, and FSM and RMI emigrants' lack of marketable skills hinders increasing revenue from remittances. Compact management committees have not discussed the countries' progress toward budgetary self-reliance and long-term economic advancement at their annual meetings.

FSM and RMI progress in key policy reforms has been slow. Country officials reported passing some new mortgage and bankruptcy laws, but other needed reforms have not been implemented. For example, according to economic experts, tax systems remain inequitable and inefficient and foreign investment regulations remain confusing and relatively burdensome. FSM and RMI development plans include reform objectives in each of these areas; however, compact management committees have not addressed the nations' slow progress in implementing reforms.

Estimated Per Capita Compact Grant Assistance for Fiscal Years 1987-2023



Source: GAO analysis of amended compacts and U.S. Census population projections.

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Abbreviations

ADB	Asian Development Bank
CNMI	Commonwealth of the Northern Marianas Islands
FSM	Federated States of Micronesia
GDP	gross domestic product
HHS	Department of Health and Human Services
IMF	International Monetary Fund
JEMCO	Joint Economic Management Committee (FSM)
JEMFAC	Joint Economic Management and Financial Accountability Committee (RMI)
MCC	Millennium Challenge Corporation
NGO	nongovernmental organization
RMI	Republic of the Marshall Islands
WDI	World Development Indicators

United States Government Accountability Office
Washington, DC 20548

June 27, 2006

Congressional Committees:

From 1987 to 2003, the United States provided about $2.1 billion in economic assistance to the Federated States of Micronesia (FSM)[1] and the Republic of the Marshall Islands (RMI) through a Compact of Free Association.[2] In 2003, the U.S. government negotiated new compact provisions with the FSM and the RMI that established an estimated $3.6 billion in continued U.S. assistance from fiscal year 2004 through fiscal year 2023.[3] These "amended" compacts provide for decreasing annual grant assistance over the 20-year period, paired with increasing contributions to trust funds that are to provide income for each country after compact grants cease. The amended compacts identify the twenty years of grant assistance as intended to assist the FSM and the RMI governments in their efforts to promote the economic advancement and budgetary self-reliance of their people. To this end, the amended compacts provide for continued economic assistance in the form of grants to sector-specific areas, such as education, health, public infrastructure, and private sector development, prioritizing education and health.

The amended compacts and their subsidiary agreements include requirements that the FSM and the RMI submit development plans and provide regular financial and performance reports. The amended compacts also require that the U.S. and the FSM Joint Economic

[1]The FSM comprises the four states of Chuuk, Kosrae, Pohnpei, and Yap. Each state has its own constitution, elected legislature, and governor and maintains considerable power, relative to the central government, to implement budgetary policies.

[2]A key goal for this assistance was to advance economic development and self-reliance for both countries. In 2000, we reviewed the impact of compact funding and found that U.S. assistance had resulted in little economic development for either the FSM or the RMI. See GAO, *Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development*, GAO/NSIAD-00-216 (Washington, D.C.: Sept. 22, 2000).

[3]For the purpose of this report, all annual references refer to the fiscal year rather than the calendar year. Note that the $3.6 billion in assistance includes (a) compact grants; (b) trust-fund contributions; (c) Kwajalein impact funding provided to the RMI government, which in turn compensates Kwajalein Atoll landowners, for U.S. access to the atoll for military purposes; and (d) estimated values of compact-authorized federal services such as weather, aviation, and postal services, at around $200 million over the 20-year period. Services associated with the Federal Emergency Management Agency have been excluded.

Management Committee (JEMCO) and the U.S. and the RMI Joint Economic Management and Financial Accountability Committee (JEMFAC) meet at least once annually to evaluate FSM and RMI progress in achieving the objectives specified within their development plans,[4] to identify problems encountered, and to recommend ways to increase the effectiveness of compact grant assistance.[5]

Regarding specific objectives within the development plans, the legislation implementing the amended compacts [6]directs JEMCO and JEMFAC to address objectives related to the implementation of policy reforms to encourage investment and to improve tax income.[7] The fiscal procedures agreements direct JEMCO and JEMFAC to monitor FSM and RMI progress toward budgetary self-reliance and long-term economic advancement.[8] The legislation implementing the amended compacts also requires that the United States and GAO periodically report on political, social, and

[4]The amended compact with the FSM requires the FSM government to prepare an official overall development plan. The RMI amended compact requires the RMI government to prepare an official medium-term budget and investment framework. The RMI has also prepared two strategic development reports entitled "Meto 2000" and "Vision 2018." In our report, we refer to the three RMI documents combined, as its development plans.

[5]JEMCO and JEMFAC were created under the amended compacts to strengthen management and accountability and to promote the effective use of compact funding. Each committee has five members, three from the United States and the other two from the FSM for JEMCO and from the RMI for JEMFAC. The Departments of the Interior, State, and Health and Human Services supply the three U.S. representatives, with the Interior representative serving as Chairman.

[6]P.L. 108-188.

[7]Specifically, the implementing legislation directs that the scope of the JEMCO and JEMFAC annual meeting, as outlined in the amended compacts, shall be construed as to read that the JEMCO and JEMFAC review required audits and reports, evaluate FSM and RMI progress in meeting objectives identified within their development plans, with particular focus on priority sectors and implementation of economic policy reforms to encourage investment and achieve self-sufficient tax rates, identify problems encountered, and recommend ways to increase the effectiveness of U.S. assistance. In this report, we use the term "address objectives" to refer to these actions.

[8]The fiscal procedure agreement for the FSM specifically states that JEMCO shall monitor FSM progress toward sustainable economic development and budgetary self-reliance in relation to its written goals and performance measures. The fiscal procedure agreement for the RMI specifically states that JEMFAC shall evaluate RMI progress to foster economic advancement and budgetary self-reliance in relation to its written goals and performance. In this report, we refer to both requirements as "monitoring." Also, FSM and RMI development plans broadly refer to the terms "sustainable economic development" and "economic self-sufficiency" in reference to their goals for long-term economic advancement.

economic conditions in the FSM and the RMI as well as on the use and oversight of U.S. assistance to those nations. In compliance with the legislation's requirement, this report[9] examines each country's (1) political and social environment regarding, respectively, compact grant implementation and health and education conditions; (2) economic environment, particularly respecting potential for achieving budgetary self-reliance and long-term economic advancement; and (3) status of economic policy reforms.

To address our reporting objectives, we reviewed U.S., FSM, and RMI annual compact reports for 2004; FSM and RMI development plans; FSM and RMI economic reports and statistics; political assessments by the U.S. Department of State (State) and Transparency International;[10] and Asian Development Bank (ADB), World Bank, and International Monetary Fund (IMF) reports on both economies. We interviewed officials from State and the U.S. Department of the Interior (Interior) as well as country experts at the ADB, the IMF, the World Bank, and the Pacific Islands Development Program at the East-West Center.[11] We also interviewed relevant officials, banks, and numerous representatives from private industry (including local chambers of commerce) in the four FSM states and in the RMI. We determined that the social and economic data presented in this report are sufficiently reliable for our purposes. We conducted our review from August 2005 through March 2006 in accordance with generally accepted government auditing standards. A detailed description of our scope and methodology is included in appendix I of this report.

Results in Brief

Although the FSM and the RMI are stable democracies, each country's political and social environments present significant challenges regarding, respectively, effective compact grant implementation and health and education conditions. Although reports by State and Interior emphasize

[9]A separate report will examine the use and oversight of U.S. assistance to the FSM and the RMI.

[10]Transparency International is a global nongovernmental organization (NGO) devoted to combating corruption. The organization consists of more than 90 locally established national chapters and chapters in formation that bring together relevant players from government, civil society, business and the media to promote transparency in elections, in public administration, in procurement and in business.

[11]The East-West center is an education and research organization established by the U.S. Congress in 1960 to strengthen relations and understanding among the peoples and nations of Asia, the Pacific, and the United States.

that both countries are established democracies with free and peaceful elections, interviews with U.S. and country officials revealed that, in each country, political factors have hindered compact implementation. For example, in the FSM, the states and national government have been unable to agree on implementation of the compact infrastructure grant. In the RMI, the national government has had difficulty securing agreement from Kwajalein Atoll land owners regarding management of public entities and the RMI governments' use of leased land for compact-related development projects. With regard to the social environment, both countries face challenging health and education conditions despite substantial expenditures. For example, both countries have relatively low rates of immunization and significant percentages of teachers who lack basic qualifications.

The economic environments in the FSM and the RMI have not improved significantly in recent years, and both countries show limited potential for development objectives of budgetary self-reliance and long-term economic advancement. As in the original compact period, both countries' economies are dependent on public sector expenditures; government spending, which accounts for about 60 percent of the gross domestic product (GDP) in each country, is funded largely by external assistance rather than domestic production. Both governments' budgets are also characterized by growing wage expenditures, exacerbating the substantial negative fiscal impacts they are likely to face with the decline of compact grants through fiscal year 2023. Increased economic assistance from other countries could support FSM and RMI budget needs and standards of living, but the degree to which such opportunities could annually offset decreased compact moneys is uncertain. Over the long term, economic growth will likely have to originate from the private sector and increased income sent home from Micronesians living abroad ("remittances"). However, the two private sector industries that the United States, the FSM, and the RMI have identified as having growth potential—fisheries and tourism—face significant barriers to expansion because of the FSM's and the RMI's remote geographic location, inadequate infrastructure, and poor business environments. At the same time, FSM and RMI emigrants' current lack of marketable skills, due to insufficient education and vocational training, is an obstacle to increased revenue from remittances. To date, JEMCO and JEMFAC have not discussed the countries' limited progress in creating conditions for budgetary self-reliance and long-term economic advancement at their annual meetings.

FSM and RMI progress in key policy reforms has been slow. Country officials reported that each of the FSM states and the RMI has implemented some legislative reforms aimed at improving the private sector environment, including bankruptcy and mortgage laws. However, according to the IMF, the ADB, and other economic experts, although such laws are necessary for an effective private sector environment, they are insufficient for stimulating investment and improving tax income without key reforms in taxes, land ownership, foreign investment regulations, and public sector management. These experts argue that the current tax systems in the FSM and the RMI are inequitable and inefficient. However, country officials reported that neither country has begun implementing fundamental tax reform, although the FSM has generally agreed on principles of a new tax system. In addition, interviews with economic experts, officials, and private sector representatives suggest that land ownership structures provide inadequate access to land for public and private investment, a problem that has not eased with the establishment of land registration offices. Economic experts and private sector representatives further describe foreign investment regulations as confusing and relatively burdensome, whereas public sector reform efforts have failed to reduce public sector competition with the private sector. FSM and RMI development plans include objectives for reforms in each of these areas, yet JEMCO and JEMFAC have not addressed these nations' slow progress in implementing reforms.

In this report, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of JEMCO and JEMFAC, to ensure that they meet requirements to address the lack of FSM and RMI progress in implementing their specified reforms to improve the business environment and encourage increased investment and tax income.

We provided a draft of this report to the Departments of the Interior, State, HHS, and Treasury, as well as to the FSM and the RMI governments. We received comments from Interior, HHS, the FSM and the RMI. Reproductions of these letters, as well as our responses to the letters, can be found in appendixes IV through VII. Interior concurred with our recommendation and expressed its intention to implement it, partly through pursuing additional information on the FSM and the RMI economies. We agree with the importance of further economic information, but we believe that sufficient information is available for the committees to meet their requirement to address FSM and RMI progress in implementing policy reform. HHS also agreed with our recommendation and requested that it be expanded to include JEMCO and JEMFAC requirements for establishing reform implementation timelines. While establishing timelines is not a requirement under the amended compact or its subsidiary agreements, we encourage the JEMCO and JEMFAC to consider this idea as one method to improve U.S. assistance. The FSM agreed with our report findings, but disagreed with our conclusion that its development prospects remain limited. We assert that the FSM could advance its compact goals through an improved business environment and actions to maximize its' unique economic opportunities. However, we maintain the importance of frank JEMCO discussion of current FSM economic realities. Finally, the RMI advocated for further JEMFAC support in policy reform implementation—highlighting the particular importance of public sector reform—and emphasized that the government has met its requirement to contribute an initial $30 million to its trust fund. While we agree with the importance of public sector reforms, the RMI's trust-fund contribution does not alter the characteristic dependence of the RMI economy on external assistance.

Background

After more than 40 years under U.S. administration as part of the United Nations Trust Territory of the Pacific Islands,[12] the FSM and the RMI became sovereign nations in 1978 and 1979, respectively. For the last 20 years, the United States' relationship with the two countries has been defined by the original Compact of Free Association and the subsequent amended Compacts of Free Association.

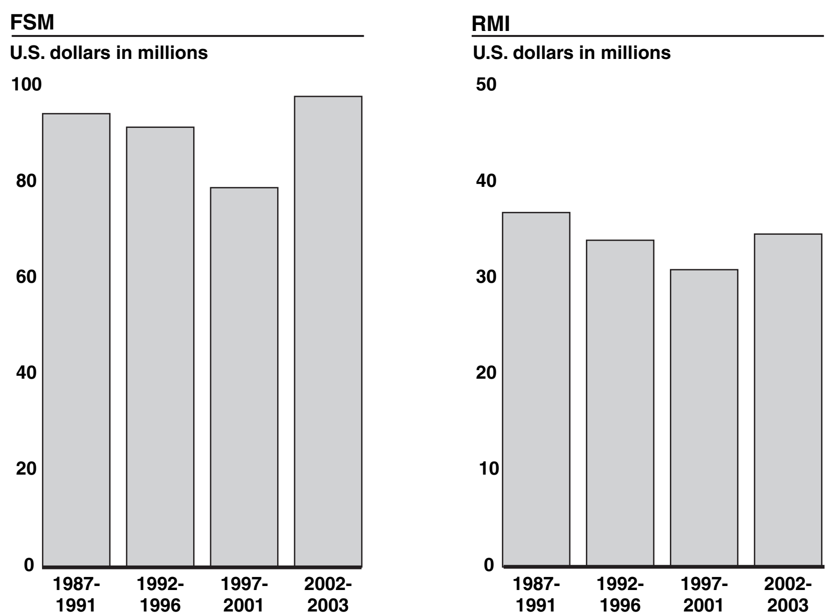
Compact of Free Association, 1986 to 2003

In 1986, the United States, the FSM, and the RMI entered into the original Compact of Free Association. Representing a new phase of the unique relationship between the United States and these island areas, the compact provided a framework for the United States to work toward achieving its three main goals: (1) to secure self-government for the FSM and the RMI, (2) to ensure certain national security rights for all of the parties, and (3) to assist the FSM and the RMI in their efforts to advance economic development and self-sufficiency. The first goal was met; the FSM and the RMI are independent nations. The second goal has also been achieved with the compact's establishment of several key defense rights for all three countries. The defense relationship continues with, among other things, U.S. access to military facilities on Kwajalein Atoll in the RMI through 2016. The compact's third goal was to be accomplished primarily

[12]The U.S. Department of the Navy began civil administration of these islands on July 18, 1947; this responsibility was transferred to Interior in July 1951. See GAO, *Foreign Assistance: Effectiveness and Accountability Problems Common in U.S. Programs to Assist Two Micronesian Nations*, GAO-02-70 (Washington, D.C.: Jan. 22, 2002).

through U.S. direct financial assistance to the FSM and the RMI. For the 15-year period covering 1987 to 2001, funding was provided at levels that decreased every 5 years. For 2002 and 2003, during negotiations to renew expiring compact provisions, funding levels increased (see fig. 1) to equal an average of the funding provided during the previous 15 years plus inflation. For 1987 through 2003, compact financial assistance to the FSM and the RMI was estimated, on the basis of Interior data, to be about $2.1 billion.[13]

Figure 1: Annual Compact Assistance to the FSM and the RMI, Fiscal Years 1987-2003



Source: GAO analysis of U.S. Department of Interior data.

Economic development and self-sufficiency were not achieved under the original compact. Both nations remained dependent on U.S. funds; total U.S. assistance accounted for more than 50 percent of government

[13]This estimate represents total nominal outlays. It does not include payments for compact-authorized federal services or U.S. military use of Kwajalein Atoll land, nor does it include investment development funds provided under section 111 of Public Law 99-239.

revenues throughout the compact period.[14] In addition, FSM and RMI GDP estimates reveal that per capita GDP at the close of the compact had not exceeded, in real terms, early 1990s levels in either country (see fig. 2).[15] Although U.S. direct assistance maintained standards of living that were higher than could be achieved without support, we found previously that compact funds spent on economic development were largely ineffective in promoting economic growth.[16] For example, compact funds were used to support general government operations that, among other things, maintained high levels of public sector employment and wages, creating disincentives to private sector growth. Compact funds were also used to support business ventures, most of which have failed. In our examination of a wide range of projects funded under the compact, we found that many projects experienced problems due to poor planning and management, inadequate construction and maintenance, or misuse of funds. In 2000, we recommended, among other things, that the Secretary of State direct the Special Negotiator for the Compact of Free Association to negotiate amended compact provisions that include assistance provided through grants targeted to priority areas, expanded reporting and consultation requirements, and the ability to withhold funds for noncompliance with compact terms and conditions.[17]

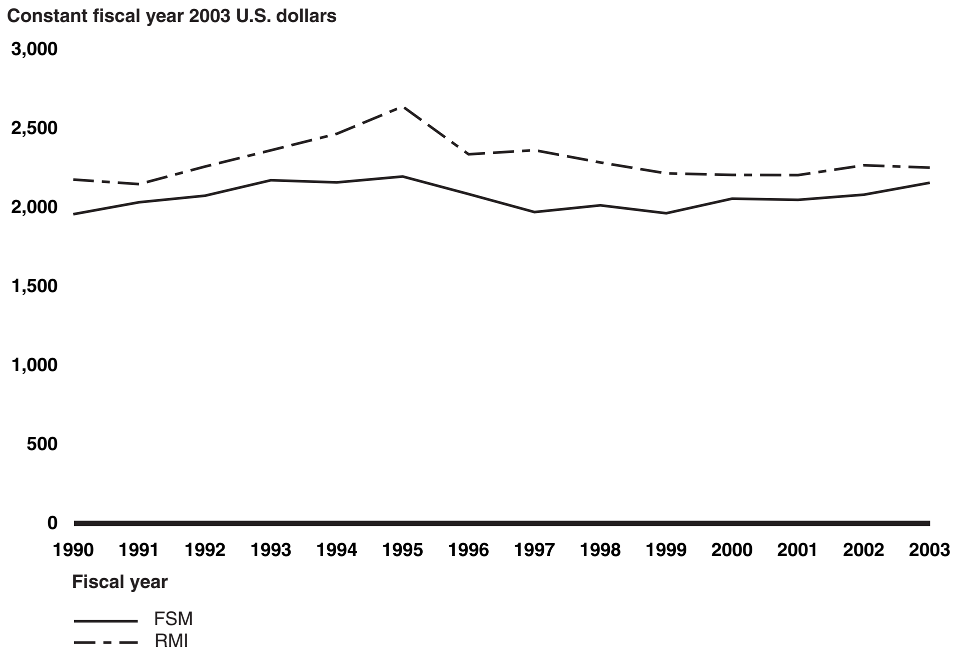
[14]In addition to providing compact grants, the United States gave the FSM and the RMI access to programs from various agencies, such as the Departments of Education and Health and Human Services. Total U.S. assistance, therefore, includes compact grants and U.S. program assistance.

[15]In the FSM, however, state per capita GDP performance varied. For example, real per capita GDP declined from 1987 to 2003 in Chuuk and Kosrae while it increased in Pohnpei and Yap.

[16]GAO/NSIAD-00-216.

[17]GAO/NSIAD-00-216.

Figure 2: Estimated FSM and RMI Real Per Capita GDP



Source: GAO analysis of FSM and RMI national accounts data.

Note: For the RMI, real GDP was determined using the U.S. price deflator for 1990 to 1995 and the RMI price deflator for 1996 to 2003.

The compact also gave citizens of both nations the rights to live and work in the United States as “nonimmigrants” and to stay for long periods of time. Further, the compact exempted FSM and RMI citizens from meeting U.S. passport, visa, and labor certification requirements when entering the United States. In 2001, we reported that during the compact, a significant number of FSM and RMI citizens had migrated to the United States and U.S. island areas.[18]

[18]We use the term “U.S. island areas” to refer collectively to Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands. See GAO, *Foreign Relations: Migration from Micronesian Nations Has Had Significant Impact on Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands*, GAO-02-40 (Washington, D.C.: Oct. 5, 2001).

Amended Compacts of Free Association

The United States negotiated separate amended compacts with the RMI and the FSM that went into effect on May 1, 2004, and June 25, 2004, respectively.[19] The amended compacts continue the defense relationship, including a new agreement providing U.S. military access to Kwajalein Atoll in the RMI through 2086;[20] strengthen immigration provisions; and provide direct financial assistance, in the form of grants, to the FSM and the RMI for fiscal years 2004 to 2023 (see table 1). To promote FSM and RMI budgetary self-reliance and economic advancement, the amended compacts and their subsidiary agreements, along with the countries' development plans, target grant assistance to six sectors—education, health, public infrastructure, the environment, public sector capacity building, and private sector development—prioritizing two sectors, education and health. In addition to providing grant assistance, the amended compacts provide for the establishment of trust funds for both countries that can provide income after annual compact grants cease. The amended compacts, their subsidiary agreements, and the U.S. implementing legislation also establish numerous reporting and accountability requirements—including the legislation's direction to the JEMCO and JEMFAC to specifically address economic policy reforms to encourage investment and improve tax income.

[19]The amended compacts and related agreements addressed most of the recommendations that we had made in past reports. See GAO, *Compact of Free Association: An Assessment of the Amended Compacts and Related Agreements*, GAO-03-890T (Washington, D.C.: June 18, 2003).

[20]Both the original and the amended compacts provide for the United States' use of portions of the Kwajalein Atoll for military and defense purposes. The new agreement provides U.S. military access to Kwajalein Atoll through 2066, with an option to extend access through 2086. See GAO, *Foreign Relations: Kwajalein Atoll Is the Key U.S. Defense Interest in Two Micronesian Nations*, GAO-02-119 (Washington, D.C.: Jan. 22, 2002).

Table 1: Annual U.S. Assistance for the FSM and the RMI under the Amended Compacts, Fiscal Years 2004 to 2023

Dollars in millions[a]

Fiscal year	FSM grants	FSM trust fund	RMI grants	RMI trust fund
2004	$76.2	$16.0	$35.2	$7.0
2005	76.2	16.0	34.7	7.5
2006	76.2	16.0	34.2	8.0
2007	75.4	16.8	33.7	8.5
2008	74.6	17.6	33.2	9.0
2009	73.8	18.4	32.7	9.5
2010	73.0	19.2	32.2	10.0
2011	72.2	20.0	31.7	10.5
2012	71.4	20.8	31.2	11.0
2013	70.6	21.6	30.7	11.5
2014	69.8	22.4	32.2[b]	12.0
2015	69.0	23.2	31.7	12.5
2016	68.2	24.0	31.2	13.0
2017	67.4	24.8	30.7	13.5
2018	66.6	25.6	30.2	14.0
2019	65.8	26.4	29.7	14.5
2020	65.0	27.2	29.2	15.0
2021	64.2	28.0	28.7	15.5
2022	63.4	28.8	28.2	16.0
2023	62.6	29.6	27.7	16.5

Source: Compact of Free Association as Amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia and the Government of the Republic of the Marshall Islands, P.L. 108-188.

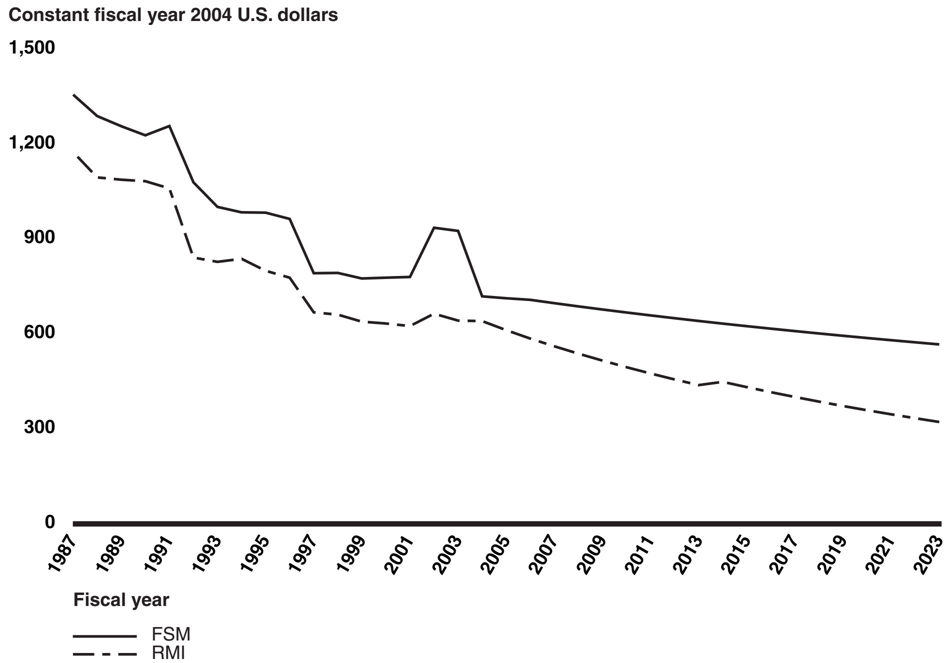
Note: These figures do not include funding for Kwajalein Atoll landowners in the RMI or the $500,000 annual audit grant that will be provided to both countries.

[a]The amounts shown in table 1 will be partially adjusted for inflation, with fiscal year 2004 as the base year. Grant funding can be fully adjusted for inflation after fiscal year 2014 under certain economic conditions.

[b]Beginning in 2014, an additional $2 million will be added to RMI annual grants to address the special needs of Kwajalein Atoll.

Including estimated inflation adjustments, total combined compact grant assistance to the two countries is projected at an estimated $3.6 billion over the 20-year assistance period. However, to provide increasing U.S. contributions to the FSM's and the RMI's trust funds, grant funding will decrease annually. Assuming current population growth estimates from the U.S. Census Bureau, this decrease in grant funding will result in falling per capita grant assistance over the funding period and relative to the original compact (see fig. 3).

Figure 3: Estimated FSM and RMI per Capita Compact Grant Assistance for Fiscal Years 1987-2023



Source: GAO analysis of amended compacts and U.S. Census population projections.

Note: Compact grant assistance was decreased in 1991, 1996, and 2001, then increased in 2002 and 2003 to equal an average of the funding provided during the previous 15 years. Compact grant assistance under the amended compacts (2004 to 2024) is decreased annually. Funding for compact-authorized federal services, trust-fund contributions, and U.S. military use of Kwajalein Atoll land is not included.

While the level of annual grant assistance to both countries decreases each year, contributions to trust funds—meant to provide an ongoing source of revenue after fiscal year 2023—increase annually by a comparable amount. In comparing projected trust fund revenue with the fiscal year 2023 grant level, we reported earlier that, under certain conditions, the trust fund revenue available in 2024 may be less than even the lower level of grant funding in 2024.[21] For example, at an assumed annual 6 percent rate of return, earnings from the FSM's trust fund would be lower than expiring grant assistance in 2024, while earnings from the RMI's trust fund would encounter the same problem by 2040.[22] If the trust funds consistently earn a higher rate of return, or if additional contributions to the funds are provided, the probability rises that the trust funds could provide a sustainable income source at the level of fiscal year 2024 grants. However, if the trust funds experience market volatility with years that have negative returns, the probability that these funds would yield income sufficient to replace expiring grant assistance declines.

FSM and RMI Face Key Political and Social Challenges

Although the FSM and the RMI are stable democracies, both countries face political and social challenges with regard to improving grant implementation and health and education conditions. U.S. and country officials told us that political conditions, including a weak federation in the FSM; disputes over public institutions' and government use of land on Kwajalein Atoll in the RMI; and both governments' lack of communication with their constituencies have hindered compact implementation and service delivery. At the same time, despite relatively high health and education expenditures, both countries face development challenges in these sectors. For example, although the Millennium Challenge Corporation (MCC)—which evaluates indicators with a relationship to growth and poverty reduction—ranks the FSM and the RMI in the top 20 percent for health expenditures relative to other lower-middle-income

[21]For our earlier analysis, see GAO-03-890T. Since 2003, the RMI has also secured trust-fund contributions from the authorities on Taiwan. However, both the FSM and RMI trust-funds experienced delays in getting invested. The RMI stated in its comments to this report that such delays will impact performance of its trust-fund in the long run. To reflect the most recent market and trust-fund information, we will be updating our trust-fund analysis in a separate report, forthcoming.

[22]In designing the trust funds, the Department of State assumed that the trust fund would earn a 6 percent rate of return in order to reflect a conservative investment strategy. This rate of return can be compared with the current average forecasted return for long-term U.S. government bonds of 5.2 percent by the Congressional Budget Office.

countries, it ranks both countries in the bottom third for a key health indicator, immunizations.[23]

Despite Stable Democratic Systems, Political Factors in the FSM and the RMI Challenge Compact Implementation

The FSM and the RMI are established democracies with free and peaceful elections. According to State and Interior, each democracy is stable despite the challenges of having hierarchical traditional structures; islands with scattered populations; and a citizenry of distinct cultures, languages, and histories. Each country also has a vocal civil society evidenced by religious organizations and nongovernmental organizations (NGO) that have been active on some political issues. Internationally, both countries also participate in various regional organizations, many of which address trade, energy, and environmental challenges faced by island nations. For example, the FSM and the RMI are members of the Forum Fisheries Agency—which promotes sustainable management of fisheries in the Pacific—and the South Pacific Applied Geoscience Commission, which promotes sustainable development of offshore resources for member countries.

Despite the two countries' stable democratic systems, interviews with U.S., FSM, and RMI officials and civil society representatives indicated that key aspects of the FSM's and the RMI's political environments hinder effective compact grant implementation.

- **Lack of government consensus.** State and Interior officials reported that the FSM's weak federal structure inhibits compact grant implementation. Because each state has its own constitution and authority over budgetary policies, the central government that is represented on JEMCO does not control the majority of compact funds and have been unable to secure agreement from the state governments regarding compact needs.[24] As a result, FSM access to the compact infrastructure

[23]The Millennium Challenge Act of 2003 (P.L. 108-199) established the Millennium Challenge Corporation (MCC) in January 2004; MCC administers the Millennium Challenge Account. Through this account, the United States provides development assistance to lower-income and lower-middle income countries that demonstrate, among other factors, a commitment to just and democratic governance, economic freedom, and investing in their people. According to the World Bank's *World Development Indicators*, the FSM and the RMI are lower-middle income countries.

[24]For example, the central government manages less than 10 percent of compact sector grants. Further, due to confusion about how the FSM consolidated budget translates into specific state resource flows, for the fiscal year 2007 budget consultations, the Department of the Interior will consult with the state governments directly, rather than through the central government.

grant, for example, has been delayed for more than 2 years owing to national and state disagreements over infrastructure priorities. Similarly, the RMI government and landowners on Kwajalein Atoll have been disputing government use of leased land and management of public entities on the atoll. Such tensions have negatively affected the construction of schools funded by compact grants and the management of the Kwajalein utility company and the Kwajalein development authority, two entities that also receive compact funds.[25]

- **Lack of government communication**. Interviews with U.S., FSM and RMI departmental officials, private sector representatives, NGOs, and external economic experts revealed a lack of communication and dissemination of information by each government on wide-ranging issues, including JEMCO and JEMFAC decisions, departmental budgets, economic reforms, legislative decisions, fiscal positions of public enterprises, and economic statistics. Additionally, private sector representatives in several FSM states reported that the public radio station serves as the government's primary means of disseminating information but is often nonoperational or censored—a complaint confirmed by the U.S. State Department's 2004 Report on Human Rights Practices in the FSM. In the RMI, a State official and an official from the RMI Council of NGO's reported that the government had been criticized—most strongly by environmental NGO's and a leading women's NGO (Women United Together Marshall Islands)—for not holding public hearings or disseminating sufficient information regarding a proposed dry dock.[26] According to the World Bank, Transparency International, and other development experts, lack of information about government activities creates uncertainty for public, private, and community leaders, which can inhibit grant performance and improvement of social and economic conditions.

[25]In addition to these examples, land issues remain a problem for U.S. access to Kwajalein Atoll through the defense provisions of the amended compact. The RMI government is bound by an agreement with the U.S. government that allows for U.S. access to Kwajalein Atoll until 2086. To date, the RMI government has not reached an agreement with Kwajalein Atoll landowners (who own the land under use by the U.S. government) that allows for this long-term access.

[26]In June 2004, RMI officials announced plans for a Taiwanese-funded floating dry dock to be placed in downtown Majuro (the capital city of the RMI). Members of the RMI's NGO community opposed this plan owing to potential negative impacts on the reef, sea life, and the downtown community.

Despite High Expenditures, Both Countries Remain Challenged in Improving Health and Education Conditions

Although FSM and RMI health and education expenditures are relatively high, certain conditions in both countries' health and education sectors are poor. According to the World Bank, among 171 countries for which it reports aid per capita, the RMI and the FSM ranked 5th and 6th highest, respectively, with per capita aid greater than $900 in 2003.[27] Much of this aid is directed toward health and education.[28] MCC provides economic assistance to developing countries, with eligibility determined partially by evaluating a country's performance—relative to other countries within its income group—on select indicators associated with economic growth and poverty reduction. MCC ranks the FSM in the top 35 percent (in the 81st and 67th percentile, respectively) for expenditures on health and primary education, and it ranks the RMI in the top 1 percent for both indicators, relative to other lower-middle income countries that qualify for MCC assistance. However, for another health-related indicator—immunizations—MCC ranks both countries in the bottom third: the FSM in the 33rd percentile and the RMI in the 13th percentile.[29] According to the World Bank's World Development Indicators (WDI), the FSM also performs relatively poorly in provision of safe water or sanitation—a service necessary for improved health outcomes. According to WDI, only 28 percent of FSM citizens have access to improved sanitation, compared with an average of 57 percent in all lower-middle income countries. In the RMI, the 1999 census suggests that 85 percent of the population has access to safe water, although the RMI 2003 statistical yearbook reports that recent tests in urban and rural areas indicate that a significant number of potable water sources, such as groundwater wells and water catchments—30 percent or more in some cases—are contaminated and deemed unsafe for human consumption. (For further information on socioeconomic

[27]Countries with higher per capita aid levels include French Polynesia, New Caledonia, Mayotte, and Palau, which also has a Compact of Free Association with the United States.

[28]As directed by the amended compacts, the FSM and the RMI have placed a priority on the health and education sectors. For example, education expenditures amounted to $221 per capita in the RMI and $192 per capita in the FSM. In the FSM, however, per capita health and education expenditures varied widely by state, reflecting variations in per capita assistance received. For example, although Chuuk state represents an estimated 50 percent of the FSM population, it receives only 38 percent of compact funds.

[29]MCC also examines girls' primary education completion, but data for this indicator were not available for either the FSM or the RMI. Regarding immunizations, the RMI had a large measles outbreak in 2003. In response to this outbreak, HHS initiated steps to improve vaccine coverage, including, among other things, assigning a public health advisor to the Pacific Islands Health Officers Association in 2005; continuing its commitment to fund a regional immunization epidemiologist to be based in the FSM; and committing to place a public health advisor in Chuuk State.

conditions in the FSM and the RMI, particularly in relation to regional averages, refer to app. II.)

Country studies and health and education officials in the FSM and the RMI also highlight other challenges—for example, the increasing prevalence of lifestyle diseases such as diabetes or hypertension; youth health issues; and poor teaching skills. According to the FSM Department of Health, 80 percent of 35 to 64 year-olds are overweight, and the number of cases involving diabetes, hypertension, heart disease, and cancer increased in the late nineties. Likewise, the RMI Ministry of Health reports that diabetes figured as the leading cause of adult morbidity in 2000 and 2001. Although the RMI has made progress in reducing overseas referrals since 2001, the rising prevalence of lifestyle diseases poses challenges for delivery of health services in both nations. The care and treatment of such diseases often involves expensive referrals abroad, lowered funding for public health programs that serve impoverished populations, and burdens on household and national budgets. Future health outlays will also be affected by health challenges facing FSM and RMI youths.[30] FSM and RMI health officials indicated concern about growing youth problems such as suicides, sexually transmitted diseases, and teen pregnancy. With regard to teacher qualifications, the FSM Department of Education reports that 90 percent of teachers need to upgrade skills to meet new certification standards (a bachelor's degree with courses in child development). In the RMI, a 2004 Ministry of Education assessment reported that more than 50 percent of teachers had failed basic English literacy tests.[31]

[30]A World Bank study highlights suicide as a serious risk for RMI youths, with 66 cases of attempted or completed suicides in 2003 (an increase of 20 percent from 2002). See World Bank, East Asia and the Pacific Region, *Opportunities That Change People's Lives: Human Development Review of the Pacific Islands - RMI Country Case Study* (Washington, D.C.: 2005). The RMI has pursued a vigorous outreach program to address this problem, however, and reported suicides fell significantly in 2005.

[31]According to the RMI's Economic Policy, Planning, and Statistics Office, only 14 percent of Marshallese staff who took the test passed both the reading and writing components.

FSM and RMI Economies Show Limited Potential for Self-reliance and Long-term Advancement

In the past 2 years, the FSM and the RMI economies have performed modestly and have been characterized by continued dependence on external assistance, suggesting limited prospects for achieving development goals of budgetary self-reliance and long-term economic advancement. Private sector employment has largely stagnated in both countries, whereas public sector expenditures continue to account for almost two-thirds of GDP. Despite the amended compacts' structure of declining grant assistance, the FSM and the RMI public sectors have grown while tax revenues remain relatively small. Unless each nation can secure other donor assistance, maintenance of living standards over the long term will likely require private sector expansion or increased remittances.[32] The FSM and the RMI private sectors face significant constraints to growth, however, and FSM and RMI emigrants' current lack of marketable skills is a hurdle to increased remittance revenue. Although the amended compacts' fiscal procedures agreements require JEMCO and JEMFAC to monitor FSM and RMI progress toward budgetary self-reliance and long-term economic advancement, neither organization has discussed these issues at its annual meeting or defined what actions they will undertake to meet this requirement.

FSM and RMI Economies Depend on Government Spending of Foreign Assistance Instead of Private Sector Production

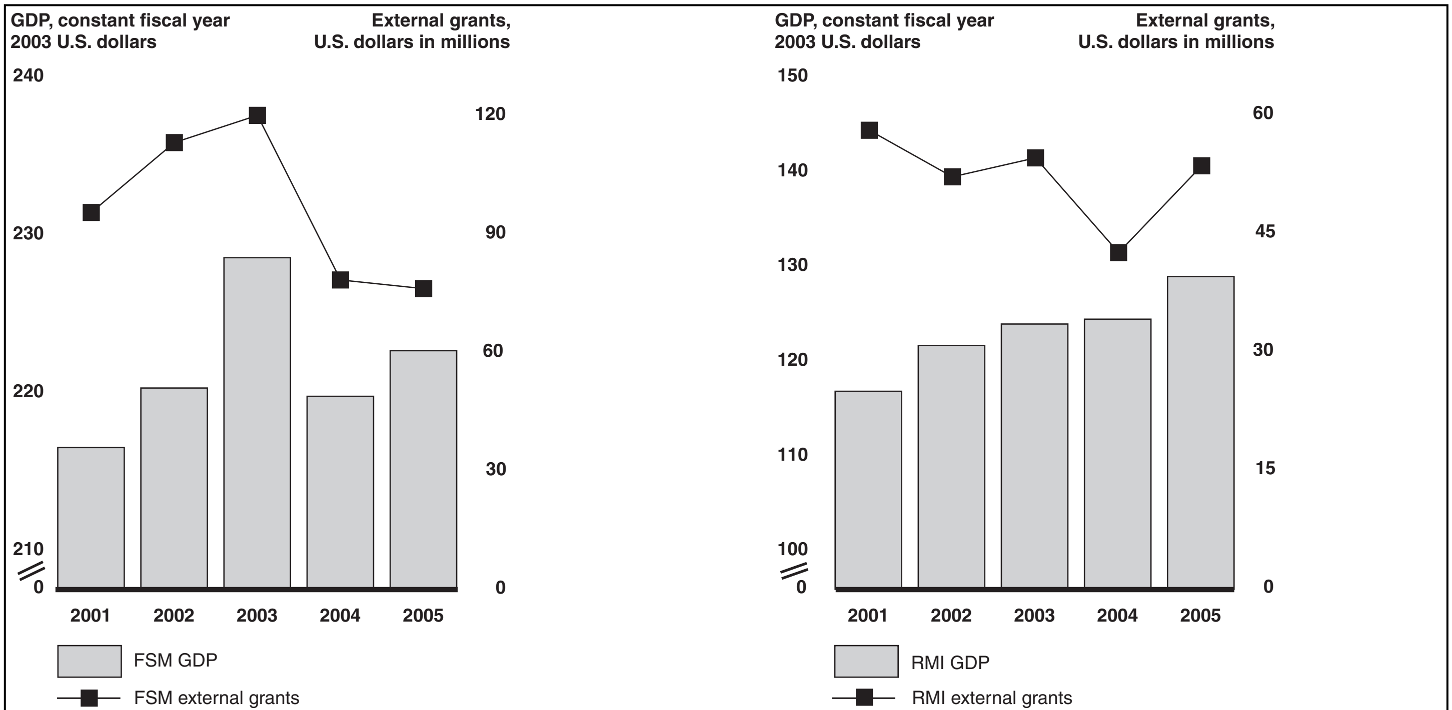
As in the original compact period, FSM and RMI economic conditions in 2004 and 2005 were characterized by dependence on foreign assistance. In the FSM, 2004 and 2005 GDP fell owing to compact delays and a lower level of assistance relative to 2003.[33] For the RMI, the IMF estimates that GDP expanded moderately owing to increased public sector expenditure (see fig. 4).[34] While the RMI also experienced compact delays in 2004, RMI public expenditure increased in both 2004 and 2005, reflecting expected compact funding at levels roughly equivalent to fiscal years 2002 and 2003, when compact funds were temporarily increased. Both countries' 2005 public sector expenditure—about two-thirds of which is funded by external grants—remained at about 60 percent of GDP.

[32]In this report, we use "remittances" to refer to funds voluntarily transferred by emigrants to their home countries.

[33]Earlier estimates by the IMF and the FSM predicted minimal GDP growth in 2005, based on an assumption of increased government expenditure; however, compact delays continued into 2005.

[34]IMF and RMI government estimates of GDP growth differ due to different inflation assumptions. According to RMI economic consultants, RMI estimates will be updated to reflect new inflation assumptions to accord more closely to those used by the IMF.

Figure 4: FSM and RMI External Grants and Estimated Real GDP



Source: GAO analysis of FSM national accounts data and IMF estimates of RMI national accounts data.

In both the FSM and the RMI, however, private sector activity has remained relatively stagnant and exists largely to provide services to the public sector. Since 2000, the estimated private sector share of GDP has fallen in both countries and only Pohnpei state in the FSM has had modest growth in private sector employment, principally in wholesale and retail operations.[35] Institutions such as the IMF and the ADB characterize the private sector in both the FSM and the RMI as isolated from international opportunities, given each economy's high dependence on imports and negligible foreign investment.[36]

[35]Both the FSM and the RMI have limited data on private sector profits. Employment data and interviews with private sector representatives confirm the lack of private sector growth.

[36]Reliable exact trade data are not available. However, current information suggests that imports exceed exports almost sevenfold in the FSM and almost fivefold in the RMI.

FSM and RMI Will Likely Face Significant Budgetary Pressure with Declining Compact Assistance.

Given the recent performance and structure of FSM and RMI government budgets, both nations are likely to face significant budgetary pressure as compact grants decline through 2023. Apart from 2002 and 2003, when compact assistance was temporarily increased, FSM national and state budgets have varied widely from year to year; however, each has had recent budget deficits. RMI government finance statistics reported by the IMF suggest that the RMI fiscal balance deteriorated after 2003 as well, with an estimated deficit equivalent to 2 percent of GDP in 2005. Economic experts emphasize that, structurally, both country's budgets are characterized by a small local revenue base and recent increases in government payroll. As a result, unless other donors provide additional assistance, expenditure reductions will be required as compact grants decline.[37]

- **FSM budget structure**. Although tax revenue in the FSM increased slightly in 2005, the FSM tax base is small and the growing wage bill is high relative to regional standards. In 2005, FSM taxes provided an estimated $29 million in revenue, or 23 percent of total revenue (compared with an average of 17 percent from 2000 to 2004).[38] In addition, the FSM government receives fishing access fees from foreign vessels that fish in its exclusive economic zone. However, the largest income source is external grants, which, at $76 million, accounted for 60 percent of revenues in 2005 (see fig. 5). In terms of expenditure, the largest FSM expenditure component is public sector wages and salaries at an estimated $60 million.[39] This component grew from 36 percent of total expenditures in 2000 to 2004 to 42 percent of total expenditures in 2005.[40]

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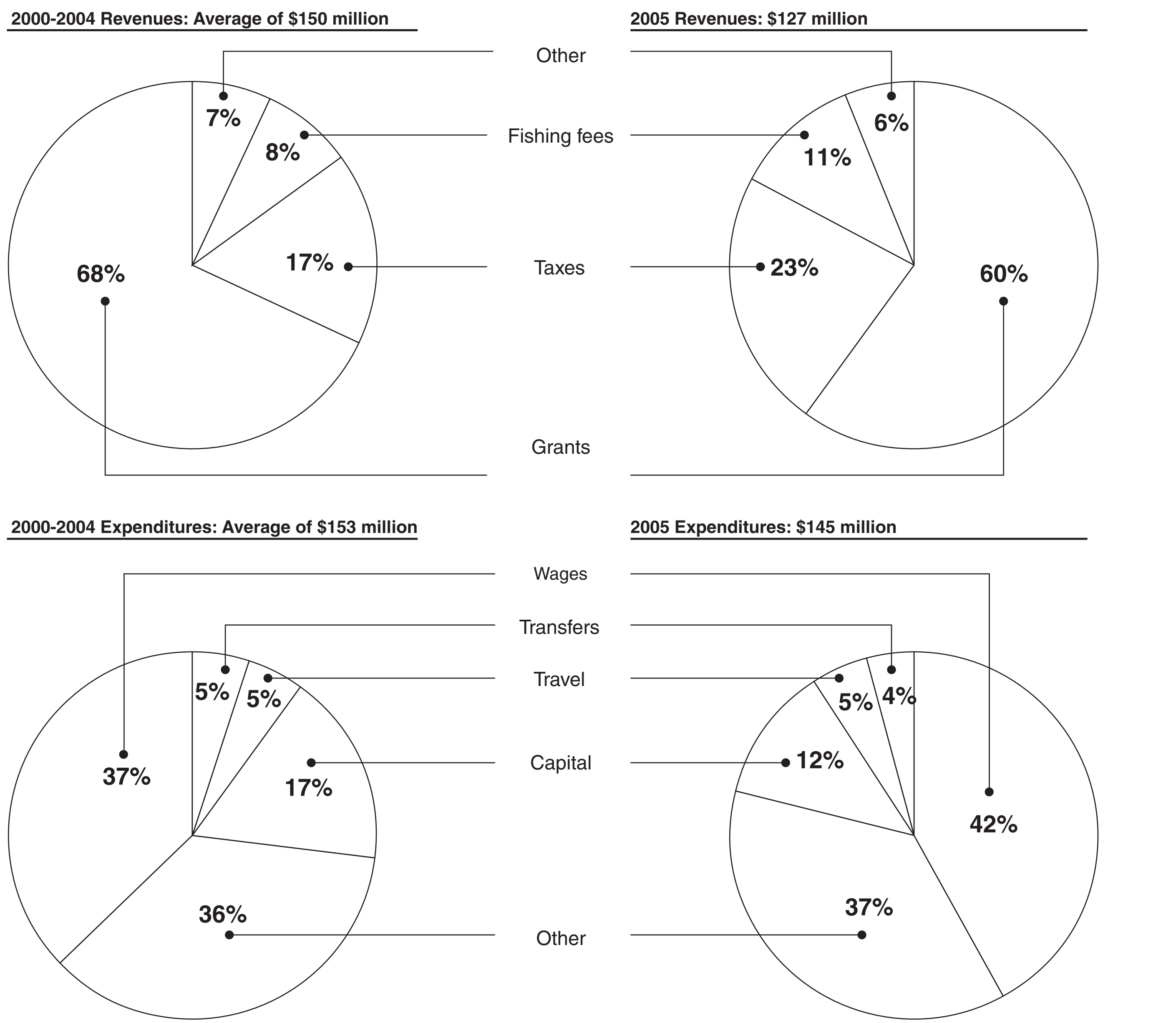
[37]Both economies scaled back public sector employment and total wage expenditures in the late 1990s as part of an ADB-financed public sector restructuring program. FSM public sector employment has varied since 2000, but the level in 2005 is the highest over the past 5 years. In the RMI, public sector employment steadily increased from 2000 to 2005.

[38]FSM tax revenue accounts for about 11 percent of GDP, compared with Fiji, Palau, Papua New Guinea, Solomon Islands, or Kiribati tax revenues, each of which accounts for more than 20 percent of GDP.

[39]The FSM public sector wage bill accounts for about 25 percent of GDP. In contrast, the public sector wage bills in Fiji, the Solomon Islands, Papua New Guinea, and Samoa account for less than 12 percent of GDP.

[40]However, the FSM fiscal outlook is complicated by varied state budget structures that create differences in fiscal vulnerabilities. For example, 2005 tax revenues ranged from 28 percent of total revenues in Pohnpei to 16 percent of total revenues in Kosrae, while the 2005 wage bill ranged from 30 percent in Yap to 57 percent in Chuuk. Moreover, the FSM will face an additional element of fiscal adjustment as it is required to phase out over 5 years its ineligible use of the compact capacity building grant for general government operations.

Figure 5: Structure of FSM Revenues and Expenditures, Fiscal Years 2000-2005

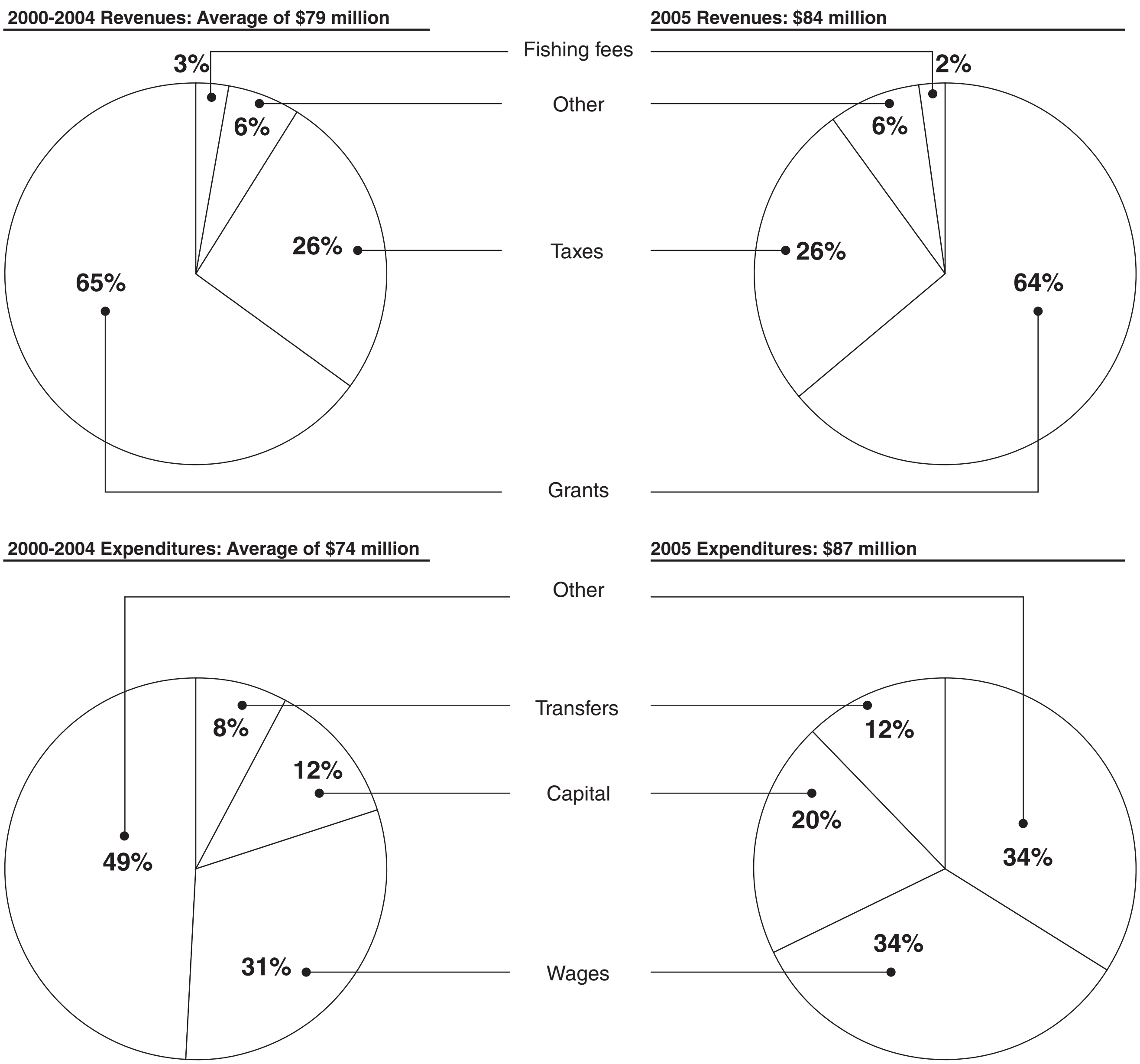


Source: GAO analysis of IMF and FSM government finance data.

Note: Transfers include subsidies and represent payments for which no goods or services are received. “Other” revenues comprise dividend and interest income, service charges, and fees. “Other” expenditures consist primarily of current expenditures on goods and services.

- **RMI budget structure.** As a percentage of total revenue, the RMI's tax base is slightly larger than the FSM's. As a percentage of total expenditure, the RMI's public sector wage bill is also relatively smaller, although its wage bill increases have exceeded the FSM's. Taxes in the RMI provide about $22 million in revenue to the government, or roughly 26 percent of total revenues (see fig. 6). The RMI also receives fishing access fees. At 64 percent of total revenues, external grants are the largest income component, providing $54 million in 2005. The structure of RMI revenues remained roughly the same over the past 5 years. However, RMI payroll expenditures increased. In 2005, the RMI's wage bill comprised 34 percent of total expenditures, compared with the 2000 to 2004 wage bill of 31 percent. In actual value, the RMI's wage bill increased from around $17 million in 2000 to around $30 million in 2005.

Figure 6: Structure of RMI Revenues and Expenditures, Fiscal Years 2000-2005



Source: GAO analysis of IMF and RMI government finance data.

Note: Transfers include subsidies and represent payments for which no goods or services are received. “Other” revenues are comprised of dividend and interest income, service charges, and fees. “Other” expenditures are comprised primarily of current expenditures on goods and services.

In addition to receiving compact grant assistance, the FSM and the RMI receive substantial U.S. program assistance from agencies such as the U.S. Departments of Agriculture, Education, and Health and Human Services. The RMI also receives large grants from Japan and Taiwan and the FSM receives large grants from Japan (see table 2) and reports having received grants from China. As compact grants decline through 2023, government fiscal balances and GDP could be supported, at least partially, by increased noncompact assistance. However, such increases in assistance are not guaranteed, may vary from year to year, and may not be flexible enough to meet FSM and RMI budget needs.[41]

Table 2: Estimated Levels of Economic Assistance by Major Donors to the FSM and the RMI, Average from Fiscal Years 2002 to 2004

U.S. dollars in millions

	Compact grants	U.S. programs[a]	Japan	Taiwan
FSM	$83[b]	$45	$8	n/a
RMI	29[b]	20	5	$10

Source: The U.S. Department of the Interior, FSM and RMI government finance statistics, the IMF, and the Organization for Economic Cooperation and Development (OECD).

Note: Some of the noncompact assistance, such as development assistance from Japan, is not included in FSM and RMI government budgets as grant assistance. In addition, China provides assistance to the FSM, although we were unable to determine the estimated amount.

[a]These figures do not include occasional emergency assistance provided by Federal Emergency Management Agency.

[b]The FSM and the RMI received less compact grant assistance than the amended compact provides, owing to delays in compact grant implementation.

Tax reform may provide opportunities for increasing annual government revenue in the FSM and the RMI. For example, business tax schemes in both nations are considered to be inefficient by the IMF, the ADB, and other economic experts owing to a poor incentive structure and weak tax collection. Various expert and country studies have concluded that substantial tax reform could bring revenue growth by broadening the tax base, altering the structure to be more equitable and business friendly, and

[41]In addition, the RMI's ADB debt repayments will be increasing in the future. The RMI estimates that annual ADB debt repayments will rise from approximately $1 million in 2005 to almost $4 million by 2012.

improving administration.[42] However, although the FSM and the RMI governments have made some improvement in tax administration, tax revenues have largely stagnated. Revenue potential from further tax reform will also vary by government (national and state) and will require factors such as a sound design; adequate resources and capacity for tax enforcement; government commitment for reform; and, ultimately, private sector growth.

Key FSM and RMI Industries Face Multiple Constraints to Growth

FSM and RMI development plans identify fishing and tourism as key potential growth industries. However, in both nations, fishing enterprises have shown poor performance, and the number of tourists has been small relative to other Pacific islands.[43] In the FSM, the fisheries and tourism sectors together provide about 6 percent of employment; commercial fishing has been plagued by poor government investments in vessels and infrastructure that have resulted in high debt levels, according to ADB experts; and visitor arrivals have remained flat over the past 10 years despite growth in Pacific island tourism. In the RMI, the fisheries and tourism sectors together provide less than 5 percent of employment; commercial fishing within the RMI's exclusive economic zone has been declining, and although visitor arrivals have increased modestly, they remain small in number relative to other Pacific island nations.[44] Economic experts suggest that the FSM and the RMI fishing and tourism industries could grow within specialized niche markets such as high-end tourism or dock services. Such opportunities remain limited in scale, however, and the IMF, the ADB and other economic experts suggest that growth in these

[42]ADB and IMF studies broadly estimate that the FSM could raise tax revenues by 25 to 30 percent by implementing a value-added tax (VAT). See Mark Sturton, *Strengthening of Public Sector Management and Administration: Compact Fiscal Adjustment and Transition*, a report prepared for ADB TA-4258, 2004 and the 2004 IMF Article IV Staff Report and Statistical Appendix for the FSM. For the RMI, estimates of revenue potential are less certain. One ADB study estimates that the RMI could raise tax revenues by about 20 percent by altering its income tax structure and streamlining import taxes. (See Fuat Andic, *Tax Policy and Administration in the RMI*, a report prepared for ADB TA-6245-REG, 2005.) However, another ADB consultant suggested that revenue gains from tax reform would be limited to less than 3 percent.

[43]The World Bank reports that international visitor arrivals in 2003 totaled approximately 18,000 in the FSM and 7,000 in the RMI, compared with 431,000 in Fiji; 92,000 in Samoa; 68,000 in Palau; 56,000 in Papua New Guinea; and 50,000 in Vanuatu.

[44]The RMI stated in its comments to this report that tax income from the fisheries and tourism sectors is also volatile.

industries in both countries may be limited by current structural barriers such as the following:

- geographic isolation and small fragmented markets;
- high airfares and poor flight connections;
- lack of adequate hotel and airport infrastructure;
- low freight capacities and poor interisland shipping;
- inadequate transshipment facilities in some areas;
- a growing threat of overfishing;
- limited pool of skilled labor; and
- high production costs in terms of labor, fuel, and other supplies.

In addition to facing structural barriers to growth, private industry in general faces a costly business environment in both the FSM and the RMI according to economic experts and U.S. and country officials. In interviews, private sector representatives also expressed concern with poor government provision of power, water, and infrastructure services and government failures to pay bills owed to the private sector for services rendered—a complaint confirmed by several government officials including those from the Chuuk State legislature, the RMI Ministry of Resources and Development, and the FSM Department of Economic Affairs (see app. III for further information).

Prospects for Increased Remittance Income to the FSM and RMI Require More Skilled Migrants

FSM and RMI emigrants could provide increasing monetary support to their home nations in the future, although evidence suggests that they are currently limited in their income-earning opportunities abroad. World Bank data show that remittances, or the personal funds that the foreign born voluntarily send to their home countries, have become an important source of financial flows to developing countries—in some cases exceeding official development assistance and foreign direct investment.[45] For the FSM and the RMI, many citizens have taken advantage of U.S. migration rights established by the original compact and extended by the amended compacts.[46] As of 2005, RMI data suggest that about 15,000 Marshallese have immigrated to the United States. FSM data suggests that almost twice as many Micronesians live overseas.[47] However, the current level of remittance income provided by these emigrants is unknown. In the RMI, the 2002 household survey suggests that RMI citizens send more money out to RMI emigrants than they receive in remittances, owing to the emigrants' lack of high-paying jobs and inability to afford repatriation of funds. Our previous work has shown that RMI and FSM emigrant populations have limited income-earning opportunities abroad, largely because of inadequate education and vocational skills.[48] The 2003 U.S. census of FSM and RMI migrants in Hawaii, Guam, and the Commonwealth of the Northern Marianas Islands (CNMI) confirms this characterization, showing that almost half of the emigrants live below the poverty line (see table 3).[49] Nonetheless, economic experts emphasize that with an upgrading of skills, the FSM's and the RMI's free access and strong historical links to the U.S. market create potential for the two nations to achieve an expansion in remittance income that could contribute to long-term economic advancement.[50]

[45]Remittances are also an important source of income to maintain standards of living for families in home countries since they are resilient to economic downturns. We reported that, for several countries, including El Salvador and the Philippines, remittances from the United States received by households on a monthly basis tend to substantially exceed the monthly minimum wage income for these countries. See GAO, *International Remittances: Different Estimation Methodologies Produce Different Results*, GAO-06-210 (Washington, D.C.: Mar. 28, 2006).

[46]U.S. Census surveys of Guam, the Commonwealth of the Northern Mariana Islands (CNMI), and Hawaii suggest that a large portion of Micronesian migrants live in these areas.

[47]As a result of emigration, FSM population growth has slowed from about 2 percent in the early 1990s to virtually zero since 1995.

[48]GAO-02-40.

[49]FSM and RMI migrants also live in other areas of the United States. A preliminary survey of RMI emigrants in Springdale, Arkansas suggests that the emigrant population there has higher education levels and lower poverty levels relative to the emigrant population in Hawaii, Guam, and the CNMI.

[50]In addition to income support from remittances, experts also suggest that returning emigrants may bring back newly acquired skills and capital that could support growth in the home economy.

Table 3: FSM and RMI Emigrants in Hawaii, Guam, and the CNMI, 2003

	FSM	RMI
Population	17,286	3,304
Percentage that migrated for employment (includes dependents)	47	25
Percentage of labor-force participants that were unemployed	21	18
Percentage of persons 25 years and older with college degree	6	7
Percentage of individuals with income below poverty level	45	49

Source: U.S. Census Bureau.

Compact Management Committees Have Not Discussed Progress toward Self-reliance and Long-term Advancement

To date, JEMCO and JEMFAC have not discussed FSM and RMI progress toward budgetary self-reliance and long-term economic advancement or the role for compact grants in attaining these development goals. FSM and the RMI development plans specify the objectives of increased private sector development, strengthened education and training, and improved public sector management as means of achieving the goals of budgetary self-reliance and long-term economic growth. The amended compacts' fiscal procedures agreements requires the JEMCO and JEMFAC to monitor FSM and RMI progress toward their long-term development objectives, however the oversight committees have not defined what actions they will undertake to meet this requirement.[51] At the fiscal year 2004 and 2005 annual JEMCO and JEMFAC meetings, as well as at a March 2006 JEMCO meeting, compact management committees focused on approving sector grants and discussing grant administration issues. For example, to approve the FSM health and education sector grants, JEMCO has required supplementary information on health insurance programs and that a certain amount of the FSM's education grant is spent on textbooks. The JEMCO meetings have not included discussion of FSM progress toward its long-term development goals. At the 2005 JEMFAC meeting, the RMI government provided a brief overview of GDP and employment data, yet the presenting official reported that there was no meaningful JEMFAC discussion of RMI long-term growth issues resulting from the presentation. For example, while the RMI government presented data on migration to the United States, JEMFAC did not discuss the linkage between compact education spending and improving RMI emigrant's skills to encourage increased remittance income over the long-

[51]Department of the Interior officials reported that their Office of Insular Affairs has contracted with the U.S. Department of Agriculture's Graduate School to assist them in preparing an economic statistics dataset for the FSM and the RMI, economic reviews for the FSM and the RMI, and a policy review for both countries.

term. Through agency comments, HHS emphasized that an annualized schedule for committee meetings does not provide enough frequency for addressing both grant administration issues and long-term growth issues, particularly given the relative lack of communication between JEMCO and JEMFAC members in between meetings. HHS suggested that communication be improved through periodic teleconference and videoconference updates.

FSM and RMI Progress on Key Economic Policy Reforms Has Been Slow

FSM and RMI officials report that they have implemented a few legislation actions to improve the private sector environment, such as bankruptcy and mortgage laws, yet progress on key policy reforms required to stimulate investment has been slow. According to FSM and RMI private sector representatives as well as various U.S., IMF, ADB, and country reports, an enabling business environment in either country requires substantial reforms in taxes, land ownership, and foreign investment regulations as well as a reduction in public sector competition with the private sector. Despite several years of policy dialogue on taxes, the FSM has agreed on elements of tax reform but has no plan for implementation and the RMI has not agreed on structural change to its tax system. In attempts to modernize complex, traditional land tenure systems, land registration offices have been established in both countries; however, in both countries, inadequate access to land and uncertainties over land ownership and land values continue to create costly disputes, disincentives for investment, and problems regarding the use of land as an asset. Further, despite amendments to foreign investment regulations, the regulations in both countries continue to be confusing and relatively burdensome, according to economic experts and private sector representatives. Finally, several years of public sector reform efforts have also failed to reduce government involvement in private sector activities. Thus far, the JEMCO and JEMFAC committees have not evaluated the lack of FSM and RMI progress in implementing economic reforms to stimulate investment and improve tax income, identified problems encountered or recommended ways to improve assistance for these objectives.

FSM and RMI Have Implemented Some Legislative Reforms

Both the FSM and the RMI identified the need for economic reform within their national development plans, and both countries have implemented or are pursuing some legislative actions. For example, FSM officials report that newly enacted legislation, although varying by state and national government, include laws for bankruptcy, mortgages, long-term leases, and secured transactions to allow movable assets to serve as collateral.

Some governments have also tried to improve foreign investment processes or created small business development centers.

To create continued and strengthened demand for reform, the ADB has also recently assisted both countries in holding several "Dialogue for Action" retreats that enable public and private sector representatives to develop a common vision for sustainable development through economic reform. Our interviews with ADB and country participants suggested that these retreats can be helpful for improving the public sector/private sector dialogue on economic challenges facing each society. However, ADB experts also emphasized that, in developing country commitment to reform, the FSM and the RMI will need to overcome the "aid curse"—or the distorted incentives for effective public sector management through, e.g., public sector downsizing, which result from dependency on large external aid flows.[52]

Key Policy Reforms to Stimulate Investment Have Not Been Implemented

Despite several years of commitment to, and recommendations for, policy reforms to stimulate investment in the FSM and the RMI, key reforms have not yet been implemented. According to FSM and RMI private sector representatives and a number of economic and country experts, policy reforms are needed in the areas of tax, land, foreign investment, and the public sector to improve business incentives and create an enabling environment for domestic and foreign investment.

Tax Reform

Tax structures in the FSM and the RMI remain complex and unequal and engender business disincentives.

- The FSM tax system has been criticized by economic experts, the FSM government, and the FSM private sector for (1) multiple taxation of the same products (2) weak administrative collection, audit, and enforcement capacity (3) taxation on a gross rather than net basis,[53] and (4) duplicative

[52]According to ADB experts, large aid transfers to the FSM and the RMI resulted in an economic development strategy where the public sector served as the engine of growth. For example, during the original compact period, large investments were made into public sector enterprises that were protected through subsidies or tax exemptions. These activities created distorted incentives for tax reform, public sector downsizing, and creation of a more open foreign investment regime.

[53]The FSM Office of Customs and Tax estimated that it collects between 40 to 60 percent of owed taxes. It attributed this low collection rate to inadequate collection and enforcement capacity and to the inability of businesses with net losses to pay taxes levied on a gross basis.

national and state tax administrations. Since 1994, the IMF and other experts have recommended, among other tax reforms, implementing a value-added tax (VAT), a simplified net profit tax, and a single modernized independent tax authority. In 2005, the FSM Task Force on Tax Reform developed a tax reform proposal, endorsed by the FSM President, that included these principles. Nonetheless, despite the fact that such reforms are estimated to require 2 to 3 years for implementation, the FSM government has neither begun to implement the proposal nor specified an implementation plan.[54] Although the FSM government has made some efforts to improve tax administration, actions by existing tax authorities in the national government and each state government continue to exhibit duplication and inefficiency.

- The RMI government and economic experts have recognized for several years that the RMI tax system is complex and regressive, taxing on a gross rather than net basis and having weak collection and administration capacity. The RMI stated in its comments to this report that their private sector representatives' most common complaint on the RMI tax system is the need for better and tighter enforcement. The RMI Office of Tax and Revenue reported that it has focused on improving tax administration and has raised some penalties and tax levels. However, legislation for income tax reform has failed and needed changes in government import tax exemptions have not yet been addressed.

Land Reform

Inadequate access to land and uncertainties over land ownership and land values continue to create costly land disputes, disincentives for investment, and problems regarding the use of land as an asset in both the FSM and the RMI.

- Land tenure systems in each nation are complex and based on traditional and customary rights, often for multiple individuals, such that most parcels do not have a registered, legal title. Our interviews with FSM and RMI officials and private sector representatives suggested that costly boundary disputes are common.

[54] According to the Task Force on Tax Reform, the FSM will need to pass a constitutional amendment to implement the tax reform proposal that revises state and national tax authorities or each state will have to pass identical tax reform legislation. FSM officials report that such an amendment had been previously introduced and failed. Our interviews with state governments suggested that they support the proposal in principle but are not yet aware of a detailed plan. Our interviews with private sector representatives suggested some resistance to the tax reform proposal.

- Land values are also uncertain owing to the lack of a developed land market or price data on lease transactions, such that banks are unable to effectively conduct mortgage secured lending. Given that a major proportion of FSM and RMI wealth lies in property, the inability to use it to secure financing for development is problematic.

- Using land for foreign investment in the FSM and the RMI is even more difficult. Economic experts report that foreigners are prohibited from owning land in both nations and are also unable to secure a valid lease when land values or ownership is uncertain.[55]

Land reform issues have been discussed in the FSM and the RMI for several years, and land registration offices have been established. However, such offices have lacked a systematic method for registering parcels, instead waiting for landowners to voluntarily initiate the process. Both the FSM and the RMI land registration offices reported that landowners have shown little interest in land registration, partly owing to the cultural issues associated with traditional land ownership structures. In the RMI, for example, only 5 parcels have been, or are currently being, registered by the land registration office. The functionality of land registration offices in both the FSM and the RMI has also been limited by a lack of registered surveyors and trained staff.

Foreign Investment Regulations

Although the FSM and the RMI have amended various aspects of their foreign investment laws to streamline the process, the overall climate for foreign investment remains complex and nontransparent, according to economic experts and private sector representatives. In the FSM, experts report that foreign investment regulations vary between states, creating confusion and additional requirements for investors who want to invest in several states. In both the FSM and the RMI, foreign investment regulations remain relatively burdensome, with reported administrative delays and difficulties in obtaining permits for foreign workers. According to an Interior official, a shipping company with service from the U.S. West Coast to Guam has for years been seeking permission to provide shipping service to the FSM and the RMI but has consistently been refused entry by those nations. The climate for foreign investment is also reportedly affected by private and public interests' protecting local businesses from

[55]The two commercial banks that operate in the FSM (Bank of Guam and Bank of FSM) also have some degree of foreign ownership such that they are unable to accept land as collateral. In the RMI, the Bank of Guam and the Bank of the Marshall Islands also have foreign-ownership that prevents them from owning land.

foreign competition. For example, experts report that foreign investment is restricted from some industries in both the FSM and the RMI, and some FSM states require a certain percentage of local ownership in foreign investment. Pohnpei state, for instance, requires 30 percent local ownership for foreign investment and prohibits foreign activity in retail, according to its Foreign Investment Board. Interviews with country officials, private sector representatives, and an ADB expert also suggest that local businesses sometimes lobby the foreign investment boards against approval of certain applications.

Public Sector Reform

Extensive FSM and RMI government involvement in commercial activities continues to hinder private sector development, owing to high public sector wages and government enterprises that directly compete with private industry. The FSM's and the RMI's public sector reform efforts since the 1990s have been based on restructuring government operations to (1) reduce the size and cost of the civil service, (2) reduce government involvement in market-oriented enterprises that could be more efficiently operated by the private sector, and (3) improve government provision of critical support services. One example of a reform success highlighted by economic experts is the RMI's restructuring of its Social Security Administration to reduce operating costs and improve service provision.[56] However, despite government endorsement of public sector reform principles, early efforts to reduce public sector employment have generally failed in both the FSM and the RMI, and the share of public sector employment has increased over the past few years. FSM and RMI public sector wages also remain about twice the level of private sector wages, contributing to the large government wage bill and effectively drawing the most skilled employees out of the private sector into public sector jobs. In addition, the FSM and the RMI governments continue to conduct a wide array of commercial enterprises that compete with private enterprises, although the share of employment accounted for by these enterprises, as well as estimated direct public enterprise subsidies, has declined in recent years (see table 4).

[56] In January of 2000, the RMI Cabinet appointed a new board for the Marshall Islands Social Security Administration (MISSA) that in turn appointed new management. The newly appointed management implemented wide ranging reforms including closer justification of expenditures, streamlining salaries and wages, elimination of job duplication, and improved use of information technology.

Table 4: FSM and RMI Government Commercial Enterprises

	FSM enterprises	RMI enterprises
Share of employment 1997-2002 average 2003-2005 average[a]	 6.2% 5.2%	 7.4% 7.0%
Annual direct subsidies 1997-2002 average 2003-2005 averagea	 $4.3 million $1.9 million	 $2.4 million $1.8 million
Estimated number of existing enterprises[b]	45	16
Examples of existing enterprises with financial losses or receiving subsidies[c]	Micronesian Petroleum Corporation (2001 subsidy = $500,000)	Copra Production Scheme (2004 subsidy = $900,000)
	Pohnpei Fisheries Corporation (2003 loss = $517,000)	Marshalls Energy Company (2004 loss = $2 million)
	Kosrae Utility Authority (2004 loss = $427,000)	National Telecom Authority (2004 loss = $980,000)
	Chuuk Public Utilities Corporation (2001 loss = $1 million)	Majuro Water and Sewer Company (2004 subsidy = $100,000)

Source: GAO analysis of FSM and RMI government finance statistics and government audit data.

[a]RMI data are available only through 2004.

[b]The FSM estimate is from a 2001 report on public enterprise reform prepared for the ADB by the Aires Group Ltd., in association with Deloitte & Touche. The list represents entities either fully owned or jointly owned by the state or national governments in 2000. The RMI estimate is derived from the 2004 *RMI Statistical Yearbook*.

[c]Financial losses represent expenditures minus revenues or the net change in assets. Economic experts highlighted several public enterprises with large financial losses (such as the FSM National Fisheries Corporation and Air Marshall Islands). These examples are not included in the table because their audit reports were qualified or contained material weaknesses.

Nonetheless, IMF and ADB officials expressed concern that the FSM and the RMI governments are not committed to reducing their participation in commercial activities, despite the fact that most of the enterprises have drained public finances through poor financial performance, requiring subsidization or entailing debt (see examples in table 4). In conjunction with the ADB, the FSM prepared a comprehensive program for public sector enterprise reform in 1999 that identified two enterprises per state and national government for privatization (such privatizations later became a condition for receiving ADB loan assistance) and entailed plans for the creation of a Public Sector Enterprise Unit.[57] This unit has not yet been fully staffed, and the ADB loan requirement was reduced to one enterprise per state and national government, a condition that has not yet been met. The RMI has yet to prepare a comprehensive policy for public enterprise reform. Our interviews with economic experts and FSM and RMI officials suggested that although they plan to privatize some public enterprises, they intend to expand others.

Compact Management Committees Have Not Addressed Slow FSM and RMI Progress in Implementing Reforms

To date, JEMCO and JEMFAC have not addressed the lack of FSM and RMI progress in implementing reforms that their development plans specify are needed to stimulate investment and improve tax income. Different from the original compact, the legislation implementing the amended compacts specifically directs the JEMCO and JEMFAC to address FSM and RMI policy reforms by (1) evaluating progress in implementing these policy reforms, (2) identifying problems encountered, and (3) recommending ways to increase the effectiveness of U.S. assistance.[58] In the 2004 and 2005 JEMCO and JEMFAC meetings, as well as in a 2006 JEMCO meeting, compact management committees focused on grant approval and administration and did not address the status of reforms or include discussions of how compact grant assistance could be leveraged to improve the policy environment for private sector growth and investment.[59] Specifically, compact management committees did not discuss the lack of FSM and RMI progress in tax, land, foreign investment, or public sector reform; factors that contributed to this lack of progress; or the interdependence of policy reform implementation with effective compact grant implementation. Opportunities exist to create linkages between grant administration and economic reforms. For example, sector

[57]See The Aires Group Ltd., *Privatization of Public Enterprises and Corporate Governance Reforms*, a special report prepared at the request of the Asian Development Bank, 2001.

[58]The implementing legislation, P.L. 108-188, directs that the scope of the JEMCO and JEMFAC annual meeting, as outlined in the amended compacts, shall be construed as to read that the JEMCO and JEMFAC review required audits and reports and (1) evaluate FSM and RMI progress in meeting objectives identified within their development plans, with particular focus on priority sectors and implementation of economic policy reforms to encourage investment and achieve self-sufficient tax rates; (2) identify problems encountered; and (3) recommend ways to increase the effectiveness of U.S. assistance. In this report, we use the term "address objectives" to refer to these actions.

[59]FSM and RMI offices related to reform efforts, such as land registration offices, have been funded with compact grants.

grants in public sector capacity building could be used to address capacity constraints that have been identified as an obstacle to reform implementation (e.g., the lack of certified land surveyors for land reform). Further, compact management committees could establish linkages between, for example, grants to tourism promotion agencies and progress in reforming foreign investment regulations to improve the private sector environment for investment or grants to private sector development offices and progress in reforming public enterprises that compete with private industry.

Conclusions

The FSM and the RMI face notable challenges to achieving budgetary self-reliance and long-term economic advancement, given their current health and education hardships; dependence on grant assistance; and need to effect reforms that are often politically, culturally, and technically difficult to implement. Tax, land, foreign investment regulation and public-sector reforms, when implemented, will improve the business environment, in turn facilitating the private sector expansion that may help the countries advance their compact goals. However, even with the needed reforms, growth in the FSM's and the RMI's private sectors may be limited by structural constraints such as geographic isolation and high transport costs. As a result, the FSM and the RMI may need to expand economic activities beyond their borders—including, as some experts suggest, expanding remittance income by equipping emigrants with better skills and, therefore, stronger income-earning opportunities abroad.

Because the amended compacts have been in place for only a few years, it is difficult to determine whether the assistance they provide will contribute to the fundamental changes in FSM and RMI economic structures and institutions necessary to achieve budgetary self-reliance and economic advancement. Expanding FSM and RMI private sector activity and remittance income will require effective compact grant implementation, just as successful compact grant implementation will require FSM and RMI commitment to policy reform. The scheduled coming reductions in U.S. grants to both countries create urgency for the implementation of policy reforms if they require fiscal resources and for capitalizing on opportunities to leverage compact assistance to improve social and economic conditions through reform.

Recommendations

To maximize FSM and RMI potential for budgetary self-reliance and long-term economic advancement, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as

Chairman of JEMCO and JEMFAC, to ensure—in coordination with other U.S. agencies participating in these committees—that they fulfill their requirements in the following three areas:

- evaluate FSM and RMI progress in implementing policy reforms needed to improve the business environment and encourage increased investment and tax income,
- identify problems encountered with policy reform implementation, and
- recommend ways to improve U.S. assistance for these objectives.

Agency Comments

We received comments from the Departments of the Interior and HHS, as well as from the FSM and the RMI. A more detailed presentation and response to the comments can be found in appendixes IV through VII. We also received technical comments from Interior, State, Treasury, HHS and the RMI. We incorporated technical comments into our report, as appropriate.

The Department of Interior concurred with our recommendation and stated that it is pursuing additional information on the FSM and the RMI economies to support its implementation of the recommendation. The RMI advocated for JEMFAC support in policy reform implementation and emphasized that public sector reforms are particularly vital. HHS also agreed with our recommendation and requested that it be expanded to include JEMCO and JEMFAC requirements for establishing timelines for policy reform implementation. While establishing timelines is not a requirement under the amended compact or its subsidiary agreements, we encourage the JEMCO and JEMFAC to consider this idea as one method to improve U.S. assistance in support of an improved FSM and RMI environment for investment and tax income. Further, Interior, HHS, and the FSM emphasized that the JEMCO and JEMFAC have thus far focused their attention on accountability issues and problems that have arisen within the various sector grants. HHS suggested that, in order to ensure the JEMCO and JEMFAC can address all pertinent short-term and long-term issues, mechanisms to improve communication and information between annual meetings—such as periodic teleconferences and videoconferences—should be pursued. The FSM viewed the report as a potentially constructive contribution to ongoing efforts to pursue budgetary self-reliance and economic advancement, yet disagreed with our conclusion that FSM development prospects remain limited.

In addition to providing copies of this report to your offices, we will send copies of this report to other appropriate committees. We will also provide copies to the Secretaries of the Interior, State, and Health and Human Services, as well as the President of the Federated States of Micronesia and the President of the Republic of the Marshall Islands. We will make copies available to other interested parties upon request.

If you or your staff have any questions regarding this report, please contact me at (202) 512-3149 or gootnickd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix VIII.

David Gootnick
Director, International Affairs
and Trade

List of Committees

The Honorable Pete V. Domenici
Chairman
The Honorable Jeff Bingaman
Ranking Minority Member
Committee on Energy and Natural Resources
United States Senate

The Honorable Richard G. Lugar
Chairman
The Honorable Joseph R. Biden, Jr.
Ranking Minority Member
Committee on Foreign Relations
United States Senate

The Honorable Richard W. Pombo
Chairman
The Honorable Nick J. Rahall, II
Ranking Minority Member
Committee on Resources
House of Representatives

The Honorable Henry J. Hyde
Chairman
The Honorable Tom Lantos
Ranking Minority Member
Committee on International Relations
House of Representatives

Appendix I: Objectives, Scope, and Methodology

The amended compacts implementing legislation requires that we report on political, social, and economic conditions in the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) as well as the use and oversight of U.S. assistance to those nations. In compliance with the legislation's requirement, this report[1] examines each country's (1) political and social environment for compact grant implementation; (2) economic conditions, including overall growth, fiscal balances, and private investment; and (3) status of economic policy reforms.

To identify key aspects of the FSM and the RMI political and social environment for compact grant implementation, we reviewed the U.S., FSM, and RMI annual compact reports for 2004; U.S. Department of State reports on FSM and RMI political systems and human rights practices; political assessments by nongovernmental organizations such as Transparency International and the University of Hawaii; and information from the Pacific Islands Forum regarding FSM and RMI participation in regional agreements and organizations.[2] We identified key areas of concern in delivery of health and education services by reviewing FSM and RMI development plans, and reports prepared in conjunction with the Asian Development Bank (ADB), the World Bank, or the United Nations Development Program.[3] We obtained FSM and RMI socioeconomic statistics on noncommunicable diseases, access to safe water and sanitation, teacher certifications and literacy skills, and Pacific Island Literacy Level student test scores from the FSM Departments of Health

[1]Our forthcoming report on the use and oversight of U.S. assistance to the FSM and the RMI will be published by December 17, 2006.

[2]The Pacific Islands Forum represents the governments of 16 Pacific islands and houses a secretariat to perform administrative tasks in support of the forum's goal of regional cooperation.

[3]These reports include: World Bank, East Asia and the Pacific Region, *Opportunities That Change People's Lives: Human Development Review of the Pacific Islands - RMI Country Case Study* (Washington, D.C.: 2005); Secretariat of the Pacific Community, in cooperation with the United Nations Development Program, *Pacific Islands Regional Millennium Development Goals Report* (Noumea, New Caledonia: 2004); United Nations Development Program, in joint publication with the RMI, *RMI Millennium Development Goals National Progress Report* (Majuro, RMI: 2005); and Asian Development Bank, *Priorities of the People Series* (http://www.adb.org/Documents/Reports/Priorities_Poor/default.asp).

and Education and the RMI Ministries of Health and Education.[4] We obtained regional socioeconomic statistics on population trends, teenage fertility, child mortality rates, immunizations, human poverty, and GDP and aid per capita from the World Bank's World Development Indicators, the U.S. Census International Database, and the 2005 United Nations Human Development Report.

To assess FSM and RMI economic conditions, we reviewed the U.S., FSM, and RMI annual compact reports for 2004; FSM and RMI development plans; recent International Monetary Fund (IMF) Article IV documents for each nation;[5] ADB Country Strategies and Program Updates; 2005 FSM and RMI Pacific Island Economic Reports (PIER) prepared in conjunction with the ADB; and expert reviews of FSM and RMI fiscal structures and tax systems.[6] We obtained data on FSM and RMI economic indicators such as gross domestic product (GDP), employment, government finances, migration, and private sector development from the IMF; the FSM's 2005 Statistical Tables; the RMI's 2004 Annual Yearbook and 2005 Employment Statistics; the OECD's international development statistics; the U.S. Department of Census; and the World Bank's World Development Indicators.

To describe the status of economic policy reforms in the FSM and the RMI, we reviewed the documents mentioned above; the FSM Tax Reform Task

[4]Safe water and sanitation is defined as access to an improved water source and sanitation, which the World Bank defines as access to a household water connection, public standpipe, borehole, protected well or spring, or rainwater collection and access to sanitation facilities (private or shared, but not public) that can effectively prevent human, animal, and insect contract with excreta. RMI teacher literacy levels were determined from the RMI Ministry of Education's 2004 administered Marshall Islands English Literacy Test for Teachers (MIELTT). The Pacific Islands Literacy Level (PILL) test is a test administered by the South Pacific Board for Educational Assessment.

[5]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members and prepares supporting documentation on economic developments and policies.

[6]These reviews include assessments by the IMF's Pacific Financial Technical Assistance Center; Fuat Andic, *Tax Policy and Administration in the RMI*, a report prepared for ADB TA-6245-REG, 2005; Mark Sturton, *Strengthening of Public Sector Management and Administration: Compact Fiscal Adjustment and Transition*, a report prepared for ADB TA-4258, 2004; Enterprise Research Institute, *Republic of the Marshall Islands Private Sector Assessment: Promoting Growth through Reform*, report prepared for ADB TA 6037, 2003; and The Aires Group Ltd., *Privatization of Public Enterprises and Corporate Governance Reforms*, a special report prepared at the request of the Asian Development Bank, 2001.

Force 2005 Report to the President; the RMI 2005 Budget Statement; ADB progress reports on the RMI Private Sector Development Project and the FSM Private Sector Development Loan; and RMI Final Reports from the 2005 Dialogue For Action Retreats sponsored by the ADB. We obtained data on FSM and RMI public sector enterprises from the FSM's 2005 Statistical Tables; the RMI's 2004 Annual Yearbook; and the most recent available public enterprise audit reports.

In addition, we held extensive interviews with officials from the U.S. Department of the Interior (Washington, D.C.; Honolulu; the FSM; and the RMI) and the Department of State (Washington, D.C.; the FSM; and the RMI). We also interviewed officials from the U.S. Departments of Treasury and Health and Human Services (Washington, D.C., and Honolulu) and experts from the ADB (Manila, the Philippines), the IMF (Washington, D.C.), the World Bank (Washington, D.C.) and the Pacific Islands Development Program at the East-West Center (Honolulu). We traveled to all four states in the FSM and to the RMI (Majuro). We met with the governor's and legislature's offices in each of the FSM states and the President's office in the RMI. We had detailed discussions with FSM (national and state governments) and RMI officials from foreign affairs, finance and budget, economic affairs, health, education, land management, tourism and fisheries, environmental protection, and audit agencies. In each location, we also met with numerous representatives from private sector businesses, banks, and community organizations.

To ensure accuracy in our report, we asked experts at the ADB, the IMF, the World Bank, the Boston Institute of Development Economics, and the University of Hawaii's East-West Center with knowledge of the FSM and the RMI economies, as well as former members of the FSM's Economic Management and Policy Advisory Team, to provide a technical review of our findings and information on the reliability of data used to support those findings. In conjunction with our own assessment, we determined that trade data, remittance data, and data on the private sector profits contained weaknesses. Exact data for these elements were not presented in the report and related findings were corroborated with other reliable data. For other social and economic data included in the report, we determined they are sufficiently reliable for our purposes.

Nonetheless, our interviews with U.S., country, and international officials revealed important constraints to the FSM's and the RMI's capacity to prepare regular, reliable, and complete data that would allow for a more thorough analysis of social and economic trends, particularly in the future. Trend data on a variety of social indicators, such as teacher qualifications and student drop-outs, could assist in evaluation of the effectiveness of compact education assistance. However, much of this data are just now being collected in a systematic way. Also, given that both nations have weak domestic capacity to produce statistics, they rely heavily on external consultants for this purpose. In the FSM, the contract for statistical assistance from external consultants has now expired. As such, both FSM and Interior officials have expressed concern for that nations' capacity to produce future statistics.

We conducted our review from August 2005 through March 2006 in accordance with generally accepted U.S. government auditing standards. We requested written comments on a draft of this report from the Departments of the Interior, State, Health and Human Services, and Treasury, as well as the governments of the FSM and the RMI. All comments are discussed in the report and are reprinted in appendixes IV through VII. Further, we considered all comments and made changes to the report, as appropriate.

Appendix II: Some Regional Socioeconomic Data for the Pacific

Economic studies of small island economies suggest common challenges for socioeconomic development. According to international development organizations, developing nations in the Pacific have exhibited relatively poor economic performance and face common constraints to growth such as geographic isolation and high transport costs. Such nations have also exhibited the need for improvements in delivery of health and education services, a challenge heightened when youths account for a large share of the population. Environmental challenges from climate change and increasing population density are also common threats to ensuring sustainable livelihoods in the Pacific. Table 5 provides estimated socioeconomic data on various Pacific island nations in order to illustrate some of these commonalities as well as areas where the FSM and the RMI characteristically differ. For example:

- The RMI has a relatively small population, but both the RMI and the FSM have a relatively large population density at 331 and 181 people per square kilometer, respectively. The RMI also has a very high teenage fertility rate.
- Except for Palau—also a nation with a Compact of Free Association with the United States—the FSM and the RMI have the highest levels of aid per capita.
- The FSM's child mortality rates are significantly lower than the RMI's, and its immunization rates are significantly higher. The RMI provides a significantly higher proportion of the population access to improved sanitation.

Table 5: Some Estimated Socioeconomic Indicators for Select Pacific Island Nations

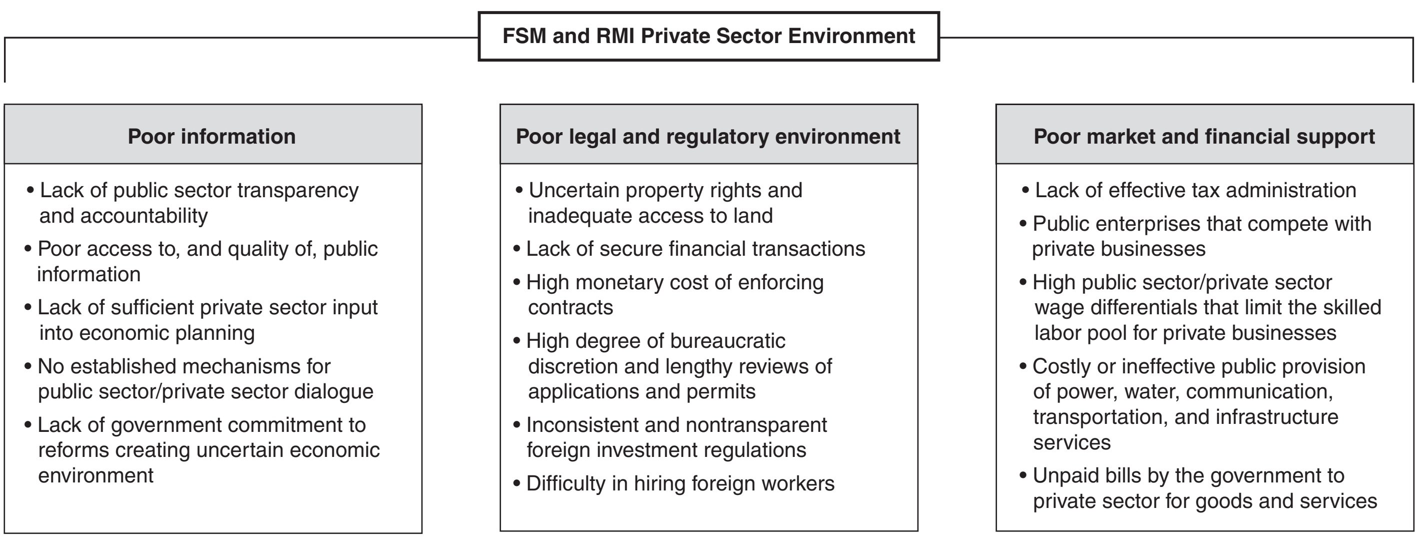
	Year	RMI	FSM	Fiji	Kiribati	Palau	Papua New Guinea	Samoa	Solomon Islands	Tonga	Vanuatu
Population, total	2005	59,071	108,105	893,354	103,092	20,303	5,545,268	177,287	538,032	112,422	205,754
Population ages 0-20 (% of total)	2005	50.1	48.9	41.5	49.9	33.5	48.0	39.8	53.1	49.1	44.6
Population density (people per sq km)	2004	331	181	46	134	43	12	63	17	141	18
Population growth (annual %)	2005	2.3	0.0	1.4	2.3	1.4	2.3	-0.2	2.8	2.0	1.6
Life expectancy at birth, total (years)	2005	70	70	67	62	70	65	71	73	70	63
Teenage fertility rate (ages 15-19)	2005	87	36	42	56	62	58	21	59	42	32
Mortality rate,under age 5 (per 1,000)	2003	61	23	20	66	28	93	24	22	19	38
Immunization, DPT(% children ages12-23 months)	2003	68	92	94	99	99	54	94	71	98	49
Access to improved sanitation facilities (% of population with access)	2002	82	28	98	39	83	45	100	31	97	50
Aid per capita (current U.S.$)	2003	991	923	61	191	1,295	40	186	132	270	154
GDP per capita (constant 2000 U.S.$)	2004	1,738	1,745	2,232	532	6,360	622	1,417	621	1,638	1,110

Sources: Population, population growth, life expectancy, and teenage fertility rates are from the U.S. Census international database. All other data are from the World Bank's World Development Indicators.

Appendix III: The FSM and RMI Private Sector Environment

Private sector representatives in the FSM and the RMI characterized the business environment in their nation as obstructive and costly. They attribute this characterization to elements of the political environment (e.g., poor information), lack of progress in economic reforms (both legal and financial), and poor government performance in providing services. World Bank national business environment surveys suggest that a high cost of doing business is a common problem for small island states. However, the survey results show that FSM and RMI business environments are particularly costly in several areas.[1] For example, of 155 countries surveyed, the FSM and the RMI are among the worst 10 to 20 countries in terms of the cost of enforcing contracts and the degree of investor protection. In interviews with private sector representatives, problems were noted with FSM and RMI business environments (see fig. 7).

Figure 7: Some Noted Problems with the FSM and the RMI Private Sector Environment



Source: GAO interviews with economic experts and FSM and RMI private sector representatives.

[1] See the World Bank's Doing Business web site at http://www.doingbusiness.org/.

Appendix IV: Comments from the Department of the Interior

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of the Interior

OFFICE OF THE ASSISTANT SECRETARY
POLICY, MANAGEMENT AND BUDGET
Washington, DC 20240

TAKE PRIDE IN AMERICA

MAY 16 2006

David Gootnick
Director, International Affairs and Trade
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Gootnick:

Thank you for the opportunity to respond to the U.S. Office of Government Accountability (GAO) draft report entitled, "Compacts of Free Association: Development Prospects Remain Limited for Micronesia and Marshall Islands" (Report).

The Report fairly states the challenges facing the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM) as the two countries attempt to effect systemic reforms required to achieve budgetary self-reliance and long-term economic advancement. The description of the political, cultural and technical obstacles to such reform is accurate, as is the listing of necessary reforms, including land, tax, and foreign investment policy. The Report's point of view is shared by the Department of the Interior and, we believe, by the Asian Development Bank, the International Monetary Fund, and other interested United States agencies, and underpins the policies of these organizations toward the freely associated states (FAS).

To maximize the FSM and RMI potential for budgetary self-reliance and long-term economic advancement, the Report recommends that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of JEMCO and JEMFAC, to ensure, in coordination with other U.S. agencies participation in these committees, that they fulfill their requirements to:

- evaluate FSM and RMI progress in implementing policy reforms needed to improve investment and tax income;
- identify problems encountered with policy reform implementation; and
- recommend ways to improve U.S. assistance for these objectives.

We concur with the Report's recommendations. The long-term issues identified in the Report are a prime concern of the JEMCO and JEMFAC, and we assert that the actions of the committees to date have been made in cognizance of the need for reforms and have been preconditions for meaningful evaluation of FAS policies. We would respectfully

See comment 1.

disagree with the Report's assertions that "JEMCO and JEMFAC have not discussed the countries' limited progress in creating conditions for budgetary self-reliance and long-term economic advancement at their annual meetings." For example, these issues were addressed extensively in the enclosed statement that the Deputy Assistant Secretary submitted for the record at the opening of the 2005 JEMCO meeting.

In its earlier report, *Compacts of Free Association: Implementation of New Funding and Accountability Requirements Underway, but Planning Challenges Remain,* GAO found that certain obstacles and problems have been encountered in Compact implementation. GAO identified oversight issues, gaps in planning, and compliance matters. JEMCO and JEMFAC have by necessity focused attention on addressing these concerns, which have included directing capacity building funds in the FSM to address basic financial management issues. While the committees may in the future direct funds to obtain certified surveyors to assist in land management reform, as the draft report suggests, the need to assure basic control of resources is a higher priority today.

See comment 2.

A current priority of the Department's Office of Insular Affairs is working with both nations in establishing elemental information needed to evaluate FAS budget and economic policies. At the direction of the Deputy Assistant Secretary for Insular Affairs, consultants provided through the U.S. Department of Agriculture Graduate School are helping the FAS prepare economic statistical data sets for the RMI and FSM. This will include an update of: gross domestic product (GDP), GDP per capita, demographic trends, income distribution and poverty data; employment statistics, wages and inflation; a monetary survey and banking indicators; balance of payments and external debt; and government finance statistics.

The consultants will also assist in the preparation of two economic reports on the progress of the FSM and RMI in attaining the economic goals stated in the strategic development plans and annual budgets. The reports will contain an analysis of economic performance of the two economies including: a review of the growth in GDP and GDP per capita (including state levels in the case of the FSM); an analysis of changes in the structure of the economies and sectoral developments; an analysis of poverty and income distribution, employment and wages; monetary developments and prices; the balance of payments and external debt; and fiscal developments. The consultants will also prepare a review of those policies enacted by the FSM national and state governments and RMI government designed to assist and promote the development of the economy and attainment of the goals of the amended Compact.

This information will be broadly applicable and will be of particular use for JEMCO and JEMFAC to evaluate progress in policy reforms. As a cautionary note, we would like to point out that JEMCO and JEMFAC do not, and should not, have the authority to control FAS policy choices and speed of implementation of FAS policy reform. Although called upon to monitor progress, the committees are not legislatures, nor may they impose solutions upon the governments. The committees' influence is limited to the authorities created by the Compact and the Fiscal Procedures Agreement.

Thank you for this opportunity to comment.

Sincerely,

R. Thomas Weimer

R. Thomas Weimer
Assistant Secretary

Enclosure

STATEMENT BY DEPUTY ASSISTANT SECRETARY DAVID B. COHEN BEFORE THE JOINT ECONOMIC MANAGEMENT COMMITTEE MEETING IN POHNPEI AUGUST 13, 2005

Good morning, and thank you for the opportunity to address this Committee. Before I begin, let me clarify that I am delivering this message not in my capacity as Chairman of JEMCO but in my capacity as head of the Office of Insular Affairs, manager of the Compact grants. I address this message both to JEMCO and to all of the FSM officials who are my colleagues in the administration of the Compact. I realize that this distinction of roles can be confusing, but my role of grants manager gives me some unique perspectives that JEMCO and my colleagues from the FSM may find helpful. I hope that no one gets confused when I refer to the members of JEMCO as "you", even though one of the "yous" is "me".

Members of JEMCO, we are at a crossroads, and the ultimate success or failure of this grand experiment that we call "Compact II" will depend upon the results of today's meeting. As the U.S. Government Accountability Office has pointed out, and as we all already know, we face real challenges. Both the U.S. and the FSM have done their best to rise up to the level of performance that Compact II demands of us. But to date, our best—I'm referring to both countries here—has not been good enough to put the FSM firmly on the path to a secure and prosperous future. For the sake of all of the people of the FSM who are depending on the Compact implementation teams from both countries, our best will simply have to get better.

Some of my fellow Pacific Islanders have observed that while we used to be able to just live for today, times have changed and we need to focus more on the future. If we don't worry about the future, we may not have a future to worry about. Eighteen years may seem like a long time for the FSM economy to grow sufficiently to survive without Compact grants. It is actually an alarmingly short period of time, given the distance that we have to travel and the institutions and policies that would have to change in order to make the journey possible.

The FSM's economy, which is based largely upon government jobs and other government expenditures funded by outside grants, is unsustainable. In order to build a stronger, more secure future, Compact grants should be used to help generate private sector economic development and local tax revenue, rather than as a *substitute* for private sector development and local tax revenue. Public sector expenditures, including payroll, should be used to ensure that the people as a whole have a better life tomorrow, rather than merely to provide a livelihood for some today. What this really means is that in order for Compact II to succeed, attitudes and institutions that were shaped by the Trust Territory economy will have to be retooled for the future. Some have claimed that Compact II is a step back towards the days of the Trust Territory. I believe that the opposite is true: Compact II creates an urgent need to for both the U.S. and the FSM to leave all vestiges of the Trust Territory mentality behind once and for all.

We commend the FSM for recognizing the need to embrace a high-growth scenario. Choosing a scenario of high growth is easy. What's difficult is making the hard decisions and short-term sacrifices that will actually lead to economic growth. We stand ready to help in any way that we can, especially through our partnership with you in the stewardship of Compact funds.

The initial years of Compact II have been a learning experience for all of us, with successes and disappointments. I am pleased that OIA's grants management team has developed an excellent relationship with our FSM colleagues. If I may say so, I think that we've assembled a great team at OIA. Many people on this team have devoted their entire careers to Micronesia. We have members of this team who have literally married into Micronesian culture, and who have children who are at least as Micronesian as they are American. Each and every member of our team knows these islands quite well and cares deeply about them. For what it's worth, I care deeply about these islands.

Every member of this team deeply values the special relationship between the U.S. and the FSM. Every member of this team deeply appreciates the service of Staff Sgt. Steven Bayow of Yap and Sgt. Skipper Soram of Pohnpei, who made the ultimate sacrifice in Iraq, and of Sgt. Hilario Bermanis and all of the other sons and daughters of Micronesia who are putting their lives on the line to defend freedom. Every member of this team deeply respects the sovereignty of the Federated States of Micronesia.

We have tried to be frank about the problems that we have found, because every strong partnership requires frankness. But we have never pointed fingers or laid blame. Our criticisms have been directed at problems, not people.

In that spirit, let me highlight an issue that, from my perspective as grants manager, can have a profound impact on the workings of JEMCO and the implementation of the Compact. I commend JEMCO for its ability to reach consensus most of the time. But why has JEMCO sometimes failed to reach consensus when both nations want good schools, good health and a strong economy? The reasons are complex, but I offer this for your consideration. It takes time to reach a consensus, and the process as it is currently managed gives us very little time. When OIA doesn't get required materials in a timely fashion, we can't spot important issues until the last minute. We then can't alert JEMCO members about important issues until the last minute, which may leave JEMCO members with insufficient time to resolve any differences that may arise among them. While it is very important for JEMCO to reach consensus, JEMCO cannot afford to be paralyzed when it fails to do so. Since JEMCO is responsible for allocating the annual Compact grants, its failure to act in a timely fashion could interrupt the flow of grant funds.

So who is to blame for JEMCO's occasional failure to reach consensus? Is the FSM guilty of being dilatory? Are the U.S. members guilty of railroading? In both cases, I say the answer is "no". The true culprit here is a lack of capacity. The GAO identified insufficient capacity on the U.S. side as a major challenge, and insufficient capacity on the FSM side is a major challenge as well. On the U.S. side, we are going to make an effort to improve our capacity. For the FSM, the Compact gives us the tools to make necessary investments in capacity. In my view, JEMCO has an absolute obligation to ensure that the FSM has the capacity to generate good information so that we can measure the success of our Compact expenditures. The FSM also needs to bolster its capacity to monitor Compact spending, to ensure that funds are reaching their intended beneficiaries. By developing the capacity to generate necessary information in a timely fashion, we will all have enough time to spot issues early on and, more importantly, JEMCO members will have enough time to thoroughly discuss and resolve any differences that may arise. I realize that it is painful in the short run to divert funds from programs to capacity building, but without the capacity to measure the results of our expenditures, we will have no way to determine which of our expenditures are wise and which are a waste of precious resources. If we allocate a little less money to programs and a little more money to true capacity building for performance measurement and oversight, we will be able to accomplish much more with a little less.

After this meeting, we must come together to find ways to improve the process so that it can more effectively serve the needs of the Micronesian people. We cannot allow process to become the enemy of progress.

Another issue that challenged us this year was the situation that we found in Chuuk, resulting in OIA's decision to withhold funds for the school nutrition program. OIA took this action in order to protect and preserve precious resources so that they could eventually be used for the benefit of the people of Micronesia. It became clear to us that money intended to feed the schoolchildren of Chuuk was not reaching those children. Investigations which have been going on for several months now hopefully will eventually determine where the money was actually going. But for OIA to keep releasing funds, month after month, when we knew that money wasn't reaching the children, would have been a dereliction of our duty as grants manager.

If we let money out the door and it gets improperly diverted, that money would probably be gone forever and would never be available to help schoolchildren. The money we withhold, on the other hand, *will* be available to benefit the people of the FSM as soon as we can establish reasonable safeguards to protect Compact funds there. Establishing those safeguards is one of the most important tasks that JEMCO faces today. The people of the FSM are waiting for you, and they deserve nothing less than your prompt action.

Finally, it has been brought to my attention that some of our Micronesian colleagues take offense when I speak about the U.S. need to protect the U.S. taxpayer investment in the FSM. Perhaps an explanation would be helpful. I noted before that the members of the U.S. grants management team care very much about the wellbeing of the FSM and its people. In my view, however, it would be very condescending of us to suggest that we care more about the FSM than its official leaders do, or that we have a better grasp of what's good for the FSM. It is the job of the FSM's official leaders to protect the interests of the FSM. We respect the fact that this is your role, and would never presume to usurp it from you. I therefore prefer to express my role not as the guardian of the FSM's interests, which would be presumptuous, but as the protector of the U.S. taxpayer investment. Those are the interests that I'm paid to protect, and I hope you can respect that. The good news is that we all want the same things: good schools, good health and good opportunity for the people of the FSM. It is the job of FSM officials to measure the success of the Compact on behalf of the people of the FSM, and it is the job of their U.S. colleagues to measure that success from the perspective of the U.S. taxpayer. Each side has to use its own judgment in making these determinations, although the Americans and Micronesians involved in this process must of course consult one another extensively as partners to try to get onto the same page. Hopefully, if the process allows enough time, JEMCO will always reach consensus. The bottom line, however, is that we all must recognize and respect each one another's roles in this partnership.

It has been suggested that the phrase "U.S. taxpayer investment" somehow suggests that the FSM is receiving welfare, rather than a quid pro quo in a partnership. That is not what it means at all. We recognize full well all of the benefits that the U.S. has received, and continues to receive, under the Compact. The bargain of Compact II, however, is that what the U.S. gives in exchange for these benefits is not free money for no particular purpose, but rather funds that are expected to have tangible and measurable results in terms of improved health, education and economic opportunity for the people of the FSM. Compact II requires the U.S. to share responsibility for ensuring that Compact funds actually reach their intended recipients and achieve their intended results.

We believe that Compact II's accountability requirements greatly benefit the people of the FSM. It would be very difficult for the FSM, which is still developing its public sector capacity, to shoulder the entire burden of ensuring that the people of the FSM receive all of the benefits that they are supposed to receive under the Compact. Under Compact II, the FSM doesn't have to assume this burden on its own: It is the joint responsibility of the FSM and the U.S. Our active involvement can only increase the likelihood that Compact funds will achieve strong, positive results for the people of Micronesia.

I understand that some have concerns about the term "investment". Perhaps this is because people associate this word with the private sector and, unfortunately, there is deep suspicion of the private sector throughout the Pacific. Let me be clear: An investment is simply an expenditure that we expect to generate a positive result. "Investment" is a very important word because when one invests, one is giving up something now so that the future will be better. The result that we're expecting from our investment—and by "we" I will presume to speak for both countries—is a good, sustainable quality of life for the people of Micronesia. The benefits of the investment go to the people of Micronesia. We call it an "investment" because we're not simply writing a check and walking away. We're sticking around to help ensure that life actually improves for Micronesians in the way our two nations intend.

Some have complained that Compact II's accountability requirements violate the FSM's sovereignty. I would argue that the FSM's ability to use outside grant funds without accountability is not a measure of its national sovereignty. That is a false sovereignty. The FSM's true sovereignty will be enhanced by its ability to develop its private sector economy and generate local tax revenue, and hence reduce its reliance on outside grants. Compact II, if implemented properly, will help the FSM to achieve a much greater level of sovereignty over its affairs.

Although Compact II contemplates the active involvement of the U.S. in managing these grants, the U.S. role should be limited. As a general rule, the U.S. should not usurp the prerogative of the FSM's leaders to decide priorities for the FSM. In my view, there are two important exceptions where the U.S. should assert its view, even if it's contrary to that of the FSM's leaders: First, we must oppose investments of Compact funds that we believe are outside the letter and spirit of the Compact, and second, we must act to protect Compact investments and maximize their chances of success. We recognize that the FSM's leaders also are responsible for pursuing these objectives. In cases where we have a difference of opinion, we must work to bridge the gap. If we are unable to come to agreement in a timely fashion, however, then we are bound to act according to our best judgment just as you are bound to act according to yours.

The record will show that every time the U.S. has asserted its will under Compact II, it has been triggered by a necessity, in our best judgment, to defend the letter and spirit of the Compact or to protect Compact investments. It is not surprising that some differences of opinion have surfaced in the early years of Compact II. We need time to work through some difficult issues. The process will get better, and we all will get better at it, over time.

And we had better get better, because the people of Micronesia may one day demand of us the accountability to which they are entitled. It is fitting that JEMCO is meeting today, on the first day of school. When I rode in from my hotel this morning, it was wonderful to see all of the schoolchildren in Kapinga Village walking to school in their bright green uniforms. But when parents who are sending their children off to school today learn that Compact education grants to FSM state governments have more than doubled since 2000, and that the U.S. is spending over $1,000 per year for each student in Micronesia, some parents on some islands may demand to know why *their* children's schools are in decrepit condition, why *their* children don't have proper textbooks, why *their* children's schools are not properly staffed, why *their* children are not receiving anything close to $1,000 worth of education. When they learn that Compact health grants to the FSM state governments have more than doubled since 2000, some people may demand to know why *their* dispensaries aren't properly staffed or stocked. If the people of Micronesia start asking these questions, if they demand to know where all that money went, what will we tell them? We should welcome the day when the Micronesian people demand that we answer difficult questions. It will help us all to become better stewards of Compact funds. Those difficult questions need to be directed to all of us and the governments that we represent. We are in this together.

So let us continue to work together as partners to make our working relationship even stronger. But let us remember that while our working relationship is very important, at the end of the day it will not be the strength or weakness of our personal relationships with one another that ultimately could cause the FSM to shortchange its future and fail to capitalize on the great promise of Compact II. It will be our collective failure to protect our common investment in the future of the FSM, our failure to recognize that time is our enemy, and that we have a very narrow window to rescue the future. It will be our collective failure to act with vision and courage, to stand up to political pressure, to stand up for change, to stand up for the people. Long after we all have moved on from our current positions, future generations of Micronesians will live with the consequences of our actions and of our failures to act. The obligation of accountability under the Compact runs not from one government to another, but from those of us from both governments who are responsible for administering the Compact to the people whose future depends on our wisdom and on our will to do the right thing. Members of JEMCO, as you do your work today inside of this room, never forget your solemn obligations to the people outside of this room, especially the young people who will inherit the future that you will help to create for them through your actions today. And let us take comfort in the fact that everyone in the room today has a common vision of that future: a future for the FSM in which the people enjoy good health, good education and abundant economic opportunity.

Members of JEMCO, you have much to accomplish today. I wish you the best of luck.

The following are GAO's comments on the Department of the Interior letter dated May 16, 2006.

GAO Comments

1. Regarding our finding that compact management committees have not discussed FSM and RMI progress toward budgetary self-reliance and long-term economic advancement at their annual meetings, we recognize that the Deputy Assistant Secretary submitted a statement for the record at the opening of the 2005 JEMCO meeting that mentioned the lack of sustainability in the FSM's economic dependence on government expenditures. However, the Deputy Assistant Secretary did not read his statement to the committee and the issue of FSM progress toward their long-term development goals was not discussed by the JEMCO.

2. We recognize that Interior has contracted with the U.S. Department of Agriculture's Graduate School to obtain further economic information on the FSM and the RMI. While we agree with the importance of gaining this further information, we believe that sufficient information is available for the committees to begin meeting their requirement to evaluate FSM and RMI progress in implementing reforms, identify problems encountered, and recommend ways to improve U.S. assistance for these objectives. For example, multiple expert studies as well as FSM and RMI commitment to, and recommendations for policy reforms in the areas of tax, land, foreign investment, and the public sector have existed since the 1990s.[1]

[1] Documents discussing these issues include, for example, IMF Article IV documents for both the FSM and RMI, dating back to 1998; ADB country assistance plans, country economic reports, and Public Sector Reform Program loan documentation, dating back to 1997 for the FSM and 1996 for the RMI; the RMI's 2000 Statement of Development Strategies entitled *Meto 2000*; the FSM's 2000 Economic Review; and the documents and information sources listed in appendix I.

Appendix V: Comments from the Department of Health and Human Services

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF HEALTH & HUMAN SERVICES Office of Inspector General

Washington, D.C. 20201

MAY 2 3 2006

Mr. David Gootnick
Director, International Affairs and Trade
U.S. Government Accountability Office
Washington, DC 20548

Dear Mr. Gootnick:

Enclosed are the Department's comments on the U.S. Government Accountability Office's (GAO) draft report entitled, "COMPACTS OF FREE ASSOCIATION: Development Prospects Remain Limited for Micronesia and Marshall Islands" (GAO-06-590). These comments represent the tentative position of the Department and are subject to reevaluation when the final version of this report is received.

The Department appreciates the opportunity to comment on this draft report before its publication.

Sincerely,

Daniel R. Levinson

Daniel R. Levinson
Inspector General

Enclosure

The Office of Inspector General (OIG) is transmitting the Department's response to this draft report in our capacity as the Department's designated focal point and coordinator for U.S. Government Accountability Office reports. OIG has not conducted an independent assessment of these comments and therefore expresses no opinion on them.

COMMENTS OF THE U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES ON THE U.S. GOVERNMENT ACCOUNTABILITY OFFICE'S DRAFT REPORT ENTITLED "DEVELOPMENT PROSPECTS REMAIN LIMITED FOR MICRONESIA AND MARSHALL ISLANDS" (GAO-06-590)

The U.S. Department of Health and Human Services (HHS) appreciates the opportunity to comment on the draft report. We look forward to working with the Government Accountability Office (GAO) on this and other pertinent issues addressed in this report.

General Comments

HHS agrees with the overall conclusions of the report. However, we believe there are some points within the report that need to be placed in context to accurately reflect the situation of these two countries.

First, the draft report provides a thorough description of the political and social conditions that inhibit the implementation of compact development plans for the Federated States of Micronesia (FSM) and the Republic of Marshall Islands (RMI). The articulated problems are significant, and in large part reflect the inertia and the lack of political will of these two Governments to make hard decisions to revamp basic policies and structures that impede change. Some changes (e.g. laws to govern the title and use of land) will be very difficult to achieve, given the cultural practices of the two countries.

See comment.

Second, we agree with the GAO's recommendation that the "Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the compact management committees, to ensure that they meet requirements to address the lack of FSM and RMI progress in implementing reforms to improve investment and tax income." However, it would be helpful for GAO to include specific recommendations to establish timelines to address policy reforms in these areas. This is especially critical given that these Governments are more than 2 years into their second amended compacts, and many of the critical changes dealing with property and tax laws could take years to implement. In other sectors, such as health and education, the necessary changes can probably be made more rapidly.

See comment.

The report also mentions that considering the amount of funding invested in FSM and RMI, the health and education indicators in both nations remain relatively poor. More specifically, the report cites low immunization rates as an example of a poor health indicator. In 2003 after a large measles outbreak in the Marshall Islands, HHS initiated steps to address this longstanding problem. These steps included: (1) the 2005 assignment of a public health advisor to the Pacific Islands Health Officers Association (PIHOA) to help manage supplies of vaccines for the Flag Territories and Freely Associated States in the Region; (2) an ongoing commitment to fund a regional epidemiology position, to be based in the FSM; (3) the January 2006 placement of a regional immunization epidemiologist in the Commonwealth of the Northern Marianas Islands; and (4) a commitment to place a public health advisor in Chuuk State, FSM, to improve immunization coverage. Through these efforts, the islands should see continuing improvement

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in vaccine coverage, even given the tremendous geographic obstacles to delivery of vaccines among the many scattered islands.

Finally, the report mentions the poor educational backgrounds of both the teachers and students in both nations, which leave young people inadequately prepared to obtain skilled jobs at home or abroad to support the local economies. Yet, because of a lack of support, the Ponape Agriculture and Trade School (PATS), founded in 1965 as a regional high school to provide vocational education to students in agriculture, construction, mechanics, and computer technology, recently closed. There appears to be no plan by the FSM government to fill this void.

Recommendations

To maximize the potential of both the FSM and RMI for budgetary self-reliance and long-term economic advancement, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the JEMCO and JEMFAC, to ensure, in coordination with other U.S. agencies that participate in these committees, that they fulfill their requirements.

GAO Recommendation One

Evaluate FSM and RMI progress in implementing policy reforms needed to improve investment and tax income.

HHS Response

See comment.

This draft places very high expectations on the JEMCO and JEMFAC. If this is the case, GAO should have considered the frequency of committee meetings and the current committee process. The compact law and the Fiscal Procedures Agreement only require these committees to meet at least once a year. So far, JEMFAC meetings have occurred only with that frequency. JEMCO has been meeting twice a year in recognition of the additional complexities of the political, social, and economic situation in the FSM. In between these meetings, there has been a relative lack of communication between the JEMCO and JEMFAC members, and there is no established secretariat for either body.

GAO Recommendation Two

Identify problems encountered with policy reform implementation.

HHS Response

Given the relative newness of the amended compacts in both countries, it has taken some time to establish the roles and responsibilities of the various structures, including JEMCO and JEMFAC, established to implement the compacts. During this transition period, much of the focus has been on systematizing the budget process and dealing with specific issues and problems that have arisen within the various sector grants. These needs have come at the expense of addressing longer-term development. There were also delays in completion, submission, and review of the national development plans required under the amended compacts. It was difficult to address long-term planning in the absence of these plans. Now that the amended compact process has stabilized and the national development plans are available, JEMCO and JEMFAC should be able to devote more time during and between meetings to the issues raised by GAO.

GAO Recommendation Three

Recommend ways to improve U.S. assistance for these objectives.

HHS Response

See comment.

HHS would be pleased to help support the mechanisms that keep the JEMCO and JEMFAC members better informed between meetings, through periodic teleconference updates, or through videoconferencing. The more dialogue that occurs, the more likely it is that the parties can address all the pertinent short-term and long-term issues.

The following is GAO's comment on the Department of Health and Human Services letter dated May 23, 2006.

GAO Comment

HHS agreed with our recommendation and requested that it be expanded to include JEMCO and JEMFAC requirements for establishing policy reform implementation timelines. The amended compacts' U.S. implementing legislation does not include establishing timelines for policy as a specific required action for the JEMCO and JEMFAC. Nonetheless, in fulfilling their requirement to identify problems encountered with policy reform implementation and recommend ways to improve U.S. assistance, the JEMCO and JEMFAC should consider this suggestion. As noted in our conclusions and by HHS, the urgency of pursuing policy reform suggests that establishing timelines for such reforms could be a useful method to improve U.S. assistance. We also appreciate HHS's suggestion to improve communication and information between annual meetings through periodic teleconferences and videoconferences and have added language to the report to reflect this suggestion. We have also added language to the report recognizing HHS's efforts to improve vaccine coverage.

Appendix VI: Comments from the Federated States of Micronesia

GAO comment supplementing those in the report text appear at the end of this appendix.

EMBASSY OF THE
FEDERATED STATES OF MICRONESIA
1725 N STREET, N.W.
WASHINGTON, D.C. 20036

Office of
the Ambassador

May 30, 2006

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Mr. David Gootnick
Director, International Affairs and Trade
United States Government Accountability Office
441 G Street, NW
Washington, D.D. 20548

RE: Comments by the Government of the Federated States of Micronesia on the GAO draft Report: "Development Prospects Remain Limited for Micronesia and Marshall Islands"

Dear Mr. Gootnick:

The Government of the Federated States of Micronesia (FSM) has no specific comment on the manner in which its current state of economic development is described in GAO's lengthy Draft Report. In fact, if these observations are viewed in the proper light and acted upon accordingly, the Report could become a very constructive contribution to the ongoing joint effort between the U.S. Government and the FSM Government to address and eventually achieve the critical Amended Compact goals of budgetary self-reliance and economic advancement in the FSM.

We do not deny that economic development in the FSM slowed during the latter phase of the original Compact period, and that this trend has continued during the early years of the Amended Compact. This trend simply must be reversed if the other goal, budgetary self-reliance, is to be attained by the year 2023.

You are correct that budgetary self-reliance cannot be attained without the economic development in the FSM that was envisioned by the U.S. and FSM negotiators of the Amended Compact. It will not be attained simply by a Drakonian application of the Amended Compact's broad new accountability provisions, which has been the sole focus of the U.S. Government thus far. It is true that those provisions are an essential component in achieving maximum effectiveness of U.S. Compact assistance, but accountability alone will not, by itself, lead to the economic future of the FSM that we all desire.

Before going further, I would like to say that the Draft Report, as presently written, could lead a reader unfairly to conclude that the obstacles to economic development in the FSM are so daunting and pervasive that economic development

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See comment.

cannot be attained. Even the present title of the Report, "...Prospects Remain Limited...," suggests that not only has the pace of development been slow, but the very prospect for development has been and remains limited. We strongly disagree with any such assertion. It is our belief that, with the right kind of partnering by the US in our efforts to develop our economy, and with the opportunities presented by the prospective submarine fiber optic cable, the development prospects of the FSM are not limited, but rather very bright. What may look to some like a Mission Impossible is in fact achievable, but, just as we see on television, only with the application of the right equipment and expertise.

I do not mean to suggest that the constraints to FSM economic growth are any less than the draft Report lists on pages 24 and 25. Several UN Summit conferences have been held to examine ways and means of overcoming these constraints, faced generally by Small Island Developing States worldwide. Nor does the FSM Government take issue with the need for the key economic policy reforms discussed in pages 28 through 36. It is incorrect, however, to suggest that the slow progress in implementing these reforms reflects a lack of commitment by the FSM. Our nation, at all levels, is trying very hard to live up to the formal commitments we made under the Amended Compact, given the resources and capacities we can bring to bear.

See comment.

The main point I would like to make is that even the full implementation of these reforms will not, in and of itself, produce economic development. They may, and hopefully will to some extent, relieve some of the FSM's budgetary distress and establish a more rational setting for private investment. They will not, without more, magically establish an upward trend of private sector development and economic progress.

I mean no disrespect to our long-standing friends and supporters in the United States, but it is a fact that throughout the period of the original Compact many if not most on the U.S. side adhered to the, "If you build it they will come" philosophy of development in our islands. That had only limited success then, and even strict accountability coupled with best efforts by the FSM Government will not make it any more successful between now and 2023.

It is regrettable, but true, that the FSM continues to have serious capacity limitations on the government side that hinder our efforts to cope promptly and effectively with the new Compact requirements. To the extent that the Draft Report seems to take account of this reality it is helpful. But limitations of capacity have an even more serious effect on the necessary growth of the FSM's private sector. Governments can assist with resources and programs, but neither governments nor multilateral agencies alone can be engines of private sector development.

See comment.

We would hope that in the years to come our discussions with the US JEMCO Members and other U.S. officials will include finding ways for the U.S. actively to assist FSM in promoting private sector business opportunities and to establish connections with the U.S. business community, aimed at building a flourishing FSM private sector. This side of the US/FSM partnership must no longer be neglected.

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On behalf of the FSM Government, I thank you for the opportunity to make these comments and will appreciate your consideration of them. In addition, I would like to express appreciation for the diligent and long-standing efforts of your Office and staff to ensure the success of the Compact of Free Association by shedding constructive light on the implementation of this complex treaty and related agreements.

Sincerely yours,

Jesse B. Marehalau
FSM Ambassador to the US

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The following is GAO's comment on the Federated States of Micronesia letter dated May 30, 2006.

GAO Comment

Regarding the FSM's disagreement with our conclusion that its development prospects remain limited—the FSM confirms the accuracy of our description of its recent economic performance, its constraints to growth, and its need for economic policy reforms. Given these current realities, we maintain that prospects for long-term economic growth in the FSM remain limited. We do not assert, however, that economic development cannot be attained. If key policy reforms were implemented, the business environment would likely improve and facilitate private sector expansion that may help the FSM advance its compact goals. Further, we agree that implementation of policy reforms will not, in of itself, produce economic development. As such, the FSM will also likely need to identify and capitalize on niche market opportunities as well as to create conditions to maximize remittance income, particularly through improving the education and health of its citizens. Establishing connections with the overseas business community may be one way to pursue such opportunities and should be included in meaningful JEMCO discussions of FSM progress toward their economic goals. As we emphasized earlier, the scheduled coming reductions in U.S. grants creates urgency for implementation of policy reforms and for capitalizing on opportunities to leverage compact assistance. The coming reductions in U.S. grants, paired with current economic realities, also suggests the need for JEMCO discussions to be based on frank assessments of current limited prospects for economic growth in the FSM and what actions need to be pursued to improve those options.

Appendix VII: Comments from the Republic of the Marshall Islands

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

EMBASSY OF THE REPUBLIC OF THE MARSHALL ISLANDS
2433 Massachusetts Avenue, N.W.,
Washington, D.C. 20008
Tel. # (202) 234-5414
Fax # (202) 232-3236

June 1, 2006

Mr. David Gootnick
Director
International Affairs and Trade
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Gootnick:

Thank you for providing the GAO Report (GAO-06-590) "Compact of Free Association Development Prospects Remain Limited for Micronesia and Marshall Islands (Draft)" to the Government of the Republic of the Marshall Islands (RMI), and for allowing my Government the opportunity to provide our comments (please see attached.)

The RMI welcomes the GAO's input and looks forward to continuing to work with the GAO to identify and address issues under the Compact of Free Association, as amended.

Sincerely,

Banny deBrum
Ambassador

Government of the Republic of the Marshall Islands
Comments on the GAO Report (GAO-06-590)
"Compact of Free Association Development Prospects Remain Limited for Micronesia and Marshall Islands (Draft)"

The following comments are based on a review of the draft document. We would hope that the changes stated and observations made are clarified and reflected in the final report.

See comment 2.

One overall comment is that the while the report focuses on economic development prospects, the study does not take into account some salient factors regarding the transition from the first Compact of Free Association term (1987-2003) and the Amended Compact's term. First, the RMI consciously set aside most of the Compact 'bump-up' funds in 2002 and 2003 into the Marshall Intergenerational Trust Fund. The majority of these funds were used as the RMI's required contribution to start Amended Compact Trust Fund. The important point is that this funding could have acted as a social and economic fiscal stimulus during those two years but, instead, was set aside with future generations in mind.

See comment 3.

The second major point was that there were delays in the initiation of the Amended Compact term which was not officially implemented until May 2004. The delays and the transition to totally new delivery, accountability and reporting mechanisms as set forth in the Fiscal Procedures Agreement, the incomplete implementation of the Supplemental Education Grant and the delay in Trust Fund start-up did have negative repercussions on public finances as well as caused uncertainty in the domestic and foreign private sector. Finally, the delay in Trust Fund start-up will impact performance of the Trust Fund in the long run. These issues were beyond the control of the RMI government.

See comment 1.

One of the major challenges regarding social and economic stability remains the size of the annual decrement of the Compact Title Two Section 211 sector grant funding ($500,000) and the only partial inflation adjustment. The resulting significant annual decline in the nominal and real value of this funding will place pressure on providing adequate social services and fiscal stability as well as impact private sector performance. This is despite the changes the RMI is making in focusing amended Compact funding mainly on health, education and infrastructure development and maintenance.

See comment 4.

Finally, the draft report fails to take into account the status of the Section 177 Settlement Agreement regarding the U.S. nuclear testing program in the Marshall Islands including the fact that the RMI has petitioned the U.S. Congress for additional measures to address the ongoing consequences of the nuclear testing under the terms of that Agreement. Section 177 and its subsidiary agreement continue in effect under the Compact, as amended, however, the U.S. has to date failed to address the long term radiological health and other burdens that the Marshallese people continue to face.

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Comments to the report:

See comment 4.

1. Economic Assistance and Military Use Payments – The report references $3.6 billion in U.S. economic assistance on page 2 and the RMI chart (Figure 1, page 8) shows Annual Compact Assistance trends. While the figure used on page 7 (Compact of Free Association, 1986-2003), $2.1 billion for 1987-2003, is footnoted and states that it does not include federal services or U.S. military use of Kwajalein atoll land. We are wondering if the other figures do contain U.S. military use funding? Payments related to land-use and contained in the Military Use and Operating Rights Agreement (MUORA) are not considered 'economic assistance' in the Compact or by the RMI. We would appreciate if the figures used are specifically classified and identified properly.

See comment 10.

2. Amended Compact Security and Defense Commitments – The Compact of Free Association 1986-2003 section states that the "second goal was achieved" concerning the Compact's establishment of key defense rights for all three countries. The statement mentions this in the past tense and no reference early on in the report (except in a footnote) to the mutual security relationship, including the use of Kwajalein atoll, in the amended Compact which are further maintained and, in fact, in place longer than the grant-related economic assistance. The economic assistance discussion in the Results in Brief section should mention the unique security and defense relationship provide for in the amended Compact. This is important for report readers to understand, especially those who may not be familiar with the previous and current Compacts.

See comment 5.

3. Focus on Health and Education – The report mentions in various places that the amended Compact funding is to make health and education a mandated priority. While we are not aware of such a requirement in Title Two or the Fiscal Procedures Agreement amongst the six sectors, the RMI has made health and education its own priority in its Medium Term Budget and Investment Framework, associated sector portfolios and other strategy and policy documents. This approach has been agreed by the JEMFAC as most sector grant and Infrastructure Development and Maintenance Program funding are for the health and education sectors. The RMI will continue this health and education emphasis for FY07.

See comment 10.

4. Footnote 7 "address" – It is not clear what this reference means.

See comment 6.

5. Growing Wage Expenditure and Tax Regime Reform – The RMI government has studied and is aware that its public sector wage costs have risen and that this has created a 'crowding out' effect vis-à-vis the private sector. We are also aware of the need for tax regime reform. We are attempting to respond to these major reform items. However, U.S. technical assistance and ADB technical assistance have not been supportive of assisting in such efforts in a way to make consistent change. The Government's focus has been on improving tax administration since in consultations with the private sector the most often repeated complaint is not about the structure of taxes but about the need for better and tighter enforcement. The Government is keen to improve the tax regime and will continue its efforts but its priority is currently on better enforcement of existing taxes.

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See comment 7.

6. Reliance on Remittances –The report highlights two possible responses to help economic growth: private sector growth and an increase in Marshallese remittances. We are concerned that GAO is emphasizing remittances as a possible economic development component. It is not the policy of the RMI government to promote emigration to the United States or the repatriation of citizen salaries and wages. Such an approach may take away from what the government's role should be- creating the enabling environment for private sector led economic growth, and thus employment growth, within the RMI. In fact providing a better environment for the development of the private sector is likely to ensure that less money is sent overseas if the private sector can receive a better return for their money domestically. The issue at the moment is largely academic since the relevant data is not available, apart from the limited data available from the Household Income and Expenditure Survey in 2003. The production of Balance of Payments and remittance data will help to quantify these flows and provide a basis for any specific policy.

See comment 1.

7. Overall Recommendation – The report's overall recommendation (page 6) is to guide JEMFAC "to ensure that they meet requirements to address the lack of FSM and RMI progress in implementing their specified reforms to *improve investment and tax income."* While we understand that the italicized part of the statement mirrors some of the amended Compact's implementing language, we are concerned about how such a statement may be interpreted by the U.S. members of the JEMFAC. I.e., we realize we must increase domestic and foreign private sector investment but the challenge is how since we have had much experience on this issue. And, regarding tax income, we realize we need tax reform but not necessarily to increase tax income.

The recommendations made in the previous paragraph of the report are more important, namely as mentioned, reforms in taxes, land ownership, foreign investment regulations, and public sector management. We have elaborated on each of these issues and have sought assistance or using our own capacities to address these issues. We require the U.S., ADB and JEMFAC support to address these major reform areas. This would involve practical assistance to help the Government implement reforms rather than further recommendations on restructuring. The Government is keen to reform but is uncertain of how to implement changes and this has been incorrectly interpreted as reluctance to reform.

See comment 4.

See comment 2.

8. Per Capita Grant Assistance – The same comment per item 1, above, applies to Figure 3. MUORA related funds should not be included or, if included, should be stated as such and noted that these are payments to Kwajalein land owners for land use. Also, it is difficult to determine if the RMI figures include the "bump-up" amounts in 2002-03. Per the introductory comment, it should be noted that the RMI set aside its 'bump-up' funding to meet its funding obligations for the Amended Compact Trust Fund. Such an effort not only showed fiscal prudence but also helped to implement the government's intent to save for future generations. This comment also relates to the initial para under 'FSM and RMI Economies Depend on Government Spending on Foreign Assistance Instead of Private Sector Production.'

See comment 10.

9. Tax Collections – One aspect that the report doesn't touch on when discussing tax collections and amounts is the vulnerability of certain tax income streams. For instance, fisheries license income does provide a significant amount in income to the

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government ($1.3-2.5 million annually) as well as associated private sector income from supporting ships. However, this figure is volatile year-to-year and the government has little control over the amounts generated since it depends on fishing patterns. Such volatility is symptomatic of other thin income streams to the government. And such volatility relates to private sector activity such as: tourism declines due to 9/11 and SARS outbreak in the early part of this decade; and increased fuel prices which have an instant negative impact on economic activity and human development indicators.

See comment 8.

10. Tourist Visits – Under 'Key FSM and RMI Industries Face Multiple Constraints to Growth' (page 24) the comment that tourism flows remain small in number relative to the RMI's neighbors may be misleading. What neighbors are being referred to? The footnote mentions Fiji, Samoa, Palau, PNG and Vanuatu which are not really neighbors. The RMI's neighbors are the FSM, Kiribati and Nauru. There are various reasons, such as air connections, relative proximity to originating countries, etc. that have to be looked at from the supply side as well as internal issues such as infrastructure and support services can be determined.

See comment 10.

11. Footnote 50 ADB Comment – This statement relates to the 1987-2001 period. It does not relate to the 'bump-up' years (2002-03) and the current amended Compact period. This should be noted.

See comment 9.

12. Public Sector Reform (page 33) – The statement that "early efforts to reduce public sector employment have generally failed" is incorrect for the RMI. The RMI has had several public sector reform efforts in the 1990s to include: 1) efforts at enterprise commercialization and privatization; 2) reducing the size of government by eliminating or spinning-off government departments and entities; and 3) civil service reform to include staff reductions. The problem is making *continuous* and *consistent* efforts.

See comment 10.

13. Policy Reforms – The section, 'Compact Management Committees Have Not Addressed Slow FSM and RMI Progress in Implementing Reforms' provides some suggestions for public sector capacity building. The RMI has applied amended Compact funds to the Marshall Islands Investment Authority for tourism promotion and has provided support for the Land Registration Office.

See comment 1.

14. Conclusion – While tax, land and foreign investment regulation reforms are mentioned in this section, the need for public sector reform (specifically civil service reform) is not mentioned yet remains vital. This is important for the RMI's development so that the public sector becomes less of an economic actor, does not 'crowd out' the private sector for employees and capital, and provides the enabling environment for private sector-led development.

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The following are GAO's comments on the Republic of the Marshall Islands letter dated June 1, 2006.

GAO Comments

1. Regarding our recommendation, we believe that economic reforms in each of the areas discussed (e.g., tax, land, foreign investment, and public sector) are needed to improve the RMI's prospects for long-term economic growth and have clarified the report language. We also agree that the annual decrement in compact grant funding is a major challenge to achieving this objective, particularly if implementation of key policy reforms requires fiscal resources.

2. We recognize that the FSM and the RMI were required under the amended compacts to contribute an initial $30 million to their trust funds. Recent RMI GDP performance may have differed if this funding were used to provide current goods and services rather than for savings. Nonetheless, the RMI's contribution to their trust fund does not alter the extent of RMI economic dependence on external assistance. Our description of RMI economic performance was also based on broad trends from 2000 to 2005, rather than exclusively on the 2 years of bump-up assistance in 2002 and 2003.

3. We will address amended compact implementation issues and trust-fund issues in two separate reports, forthcoming. We have also added language to this report indicating the RMI's concern over delays in setting up its trust fund.

4. We have clarified our estimates and figures with regards to funding streams they include and exclude. Section 177 funds are not included in our analysis.[1]

[1]The compact served as a vehicle to reach a full settlement of all compensation claims related to U.S. nuclear tests conducted on Marshallese atolls between 1946 and 1958. In a compact-related agreement (pursuant to Section 177), the U.S. government agreed to provide $150 million to create a trust fund. While the compact and its related agreements represented a full settlement of all nuclear claims, it provided the RMI with the right to submit a petition of "changed circumstance" to the U.S. Congress requesting additional compensation. The RMI government submitted such a petition in September 2000. In November 2004, the U.S. Department of State issued a report evaluating the legal and scientific basis of this petition. The report concludes that there is no legal basis for considering additional payments. The House Committee on Resources and the Subcommittee on Asia and the Pacific of the House Committee on International Relations held a joint hearing on the petition on May 25, 2005. The Senate Committee on Energy and Natural Resources held an oversight hearing on the effects of the U.S. nuclear testing program on the Marshall Islands on July 19, 2005.

5. Section 211 of Title Two of the Amended Compact with the RMI states that compact grants shall be used for assistance in education, health care, the environment, public sector capacity building, and private sector development, or for other areas as mutually agreed, with priorities in the education and health sectors.

6. We have added language regarding RMI consultations with the private sector and their desire for improved tax enforcement. The effectiveness of U.S. and ADB technical assistance to the RMI is outside the scope of this report. We note, however, that the RMI allocated no compact funding to a public sector capacity building grant in fiscal year 2004 and less than 1 percent of compact sector grant funding to such a grant in fiscal year 2005.

7. We discuss remittances in our report as one option that the RMI may consider in pursuing the economic goals under the amended compact and that the JEMFAC may consider when discussing compact grant implementation. In the RMI's METO 2000 Statement of Development Strategies and its 2001 Strategic Development Plan entitled "Vision 2018," the RMI estimates that between 500 to 800 new job entrants will need to find employment each year from 1999 to 2009. To meet this objective, the ready access provided under the compact for Marshallese to live and work in the U.S. must be preserved. These documents also emphasize that the education system needs to equip Marshallese to succeed both in the RMI and abroad. Economic experts have emphasized that the RMI's free access and strong historical links to the U.S. market provide the RMI with relatively good opportunities to expand remittance income, particularly if migrants had upgraded skills. Improved skill provision should benefit both RMI emigrants as well as domestic economic prospects.

8. We have clarified our reference that 2003 data on international visitor arrivals are for other Pacific island nations. Such data are not available for Kiribati and Nauru. The World Bank has estimated that, in 2002, Kiribati had 5,000 international visitors. However, Kiribati also has a per capita GDP that is less than one-third of the RMI's.

9. RMI employment data indicate that the RMI did succeed in reducing public sector employment from about 3,760 jobs in 1997 to about 3,530

jobs in 2001.[2] However, since then, public sector employment has risen to about 4,320 jobs in 2005.

10. We have modified language in the report to clarify each of these points. We have added language to the report to include the volatility in tax income from the fisheries and tourism sectors and the fact that RMI offices related to reform efforts, such as land registration offices, have been funded with compact grants.

[2]Public sector employment data includes jobs in the RMI national and local governments, government agencies, and public-sector enterprises.

Appendix VIII: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

In addition to the persons named above, Emil Friberg, Assistant Director; Leslie Holen; Reid Lowe; Mary Moutsos; Kendall Schaefer; and Seyda Wentworth made key contributions to this report.

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