Report to the Congress

on the

Compacts of Free Association

with

the Federated States of Micronesia
and the Republic of the Marshall Islands

For Fiscal Year 2005

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Introduction

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

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

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

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

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

Section 104(h) of Public Law 108-188 requires a Report by the President of the United States on the FSM and the RMI to discuss general social, political, and economic conditions, including, among other things, estimates of economic growth, per capita income, and migration rates.

Federated States of Micronesia (FSM): Background

Despite decades of significant United States economic and financial support and wide-ranging contacts with the rest of the world, the government of the FSM has not developed indigenous capacity to generate and disseminate economic and financial information and formulate they type of economic and financial policy that modern economies routinely engage in. Even basic statistics on the various components of the national economy, the various state economies, the tax base, population, labor force, employment, wages, salaries and pensions and other commonly followed elements in the Pacific such as migration are not routinely compiled unless such activities are undertaken by outsiders.

Both the FSM national government and the four states consider the provision and dissemination of economic and financial information a luxury and, therefore, do not include it routinely in the national and state budgets. It is not entirely clear why, but government in the FSM, attaches little value to economic and financial information which leaves the citizenry uninformed about the economy, its performance and prospects and connections to the outside world. This continues to be the case even when there are requirements and financial provisions for monitoring economic and financial progress during the amended Compact in which capacity building, including compiling and disseminating economic and financial information, is one of the major areas of focus.

A succession of foreign advisory teams, including the Economic Management Policy Advisory Team (EMPAT), funded in part by the United States since its beginning in the mid-1990s, has been employed over the past decade to generate and disseminate macroeconomic data and offer economic and financial advice to the national and state governments. Despite excellent work by outside entities, the skills to continue this work have rarely been transferred to FSM government staff who could continue this work independently. On those rare occasions that local staff has gained a certain degree of competence in such endeavors, they have found better job prospects elsewhere. In fact, EMPAT's engagement ended at the end of 2004 and no successor mechanism was put in place. With the departure of EMPAT, there is the likelihood that there will be once again a deficit of credible economic and financial data.

The amended Compact with the FSM provides for a certain level of economic and financial aid every year through FY 2023, but places greater and more explicit emphasis than did the original Compact on expanding the productive capacity of the economy in a more predictable manner. This is to occur through improvements in public infrastructure, public health, public education, public sector capacity building, the environment, and institutional reforms that would make the FSM a more open and attractive market to overseas capital and skills. These improvements would also be seen by global and regional development assistance providers as signs of progress and reasons to invest some of their resources in the FSM.

Unlike the first Compact, the amended treaty provides for the creation of a trust fund for the people of the FSM that, if maintained with the prudence that successful public trust funds require, will generate a reliable income stream after 2023. Starting in 2005, both the United States and the FSM deposit annually certain amounts into the trust fund until 2023. Over the 20-year period ending in 2023, the trust fund will have accumulated a reserve of sufficient level that would generate interest income to replace the operational (sector) grant payments from the United States. To put it differently, interest income from the trust fund is expected to replace U.S. sector grants and offer the FSM Government not only a reliable source of income but a greater degree of control over its disposition after this phase of the Compact in concluded.

Since the total U.S. grant drops by a certain amount every year until 2023, with the amount of reduction going into the trust fund, the operating grant will be smaller every year, making it more likely that the interest income from the trust fund will be sufficient to replace direct U.S. payments. To compensate for the operational (sector) grant reduction every year until 2023, the FSM national and its four state governments will have to make the necessary adjustments in their budget proposals to the Joint Economic Management Committee (JEMCO). Alternatively, the FSM national and its four state governments may find other sources of income such as taxes and fees to make up for the decrements in the operating grants from the United States. With 18 years of reliable operational grant and trust fund deposits, the amended Compact provides the people of the FSM a horizon of sufficient length in which to plan and map out the post-Compact phase of their economic and financial destiny.

The year 2023 may appear so far in the future as to give political and traditional leaders in the FSM a false sense of comfort and security. However, long-term viability of the FSM economy beyond a steady flow of U.S. assistance (Compact grants and other federal aid) would require the hard work ahead to start immediately. This would entail identifying those areas of the economy, current and future, where scarce resources would be best invested. With those areas of the economy that would require development policies and investment plans, the FSM leadership would then start the search for resources that would make it possible to move toward a more self-sufficient economy. The main objective of this plan would be to steer the FSM's post-Compact economy toward a sustainable standard of living for the entire population.

The resources to make prosperity possible in the post-Compact era may come from global and regional assistance providers such as the International Bank for Reconstruction and Development (IBRD), otherwise known as the World Bank, the Asian Development Bank, other bi- and multilateral agencies and governments in the Asia-Pacific region such as Japan and Taiwan which already provide a significant amount of assistance to the region. To secure funds of a certain level from these providers that would make a difference in the FSM economy, especially in its small and remote states, the work has to begin now, and an important part of that work has to be continued assessment of what the economy's productive capacity is, how it performs, how it evolves, and what its best future can be.

In the spirit of the joint undertaking that the amended Compact is, the enabling legislation, Public Law 108-188 section 140(h)(1), requires this annual economic and financial report on the FSM by the United States Government. It will give the United

States Congress information on, among other things, the use and effectiveness of United States financial, program, and technical assistance funds, the status of economic policy reforms, and the status of the efforts to increase investment in the FSM's aggregate productive capacity.

This report for the fiscal Year 2005, the second since the amended Compact took effect, is submitted in fulfillment of that requirement. The report is based largely on two sources of data: (1) economic, financial and demographic data compiled by EMPAT consultants and others who advised the FSM government during the year, (2) the FSM Government's first Report to the President of the United States, required by Section 214 of the amended Compact. The FSM's Report is to outline the use of United States grant assistance and other assistance and progress in meeting mutually agreed program and economic goals. The first Report was received by the Department of the Interior in August 2005 and subsequently transmitted to the Executive Office of the President.

Economic and Financial Review of the FSM

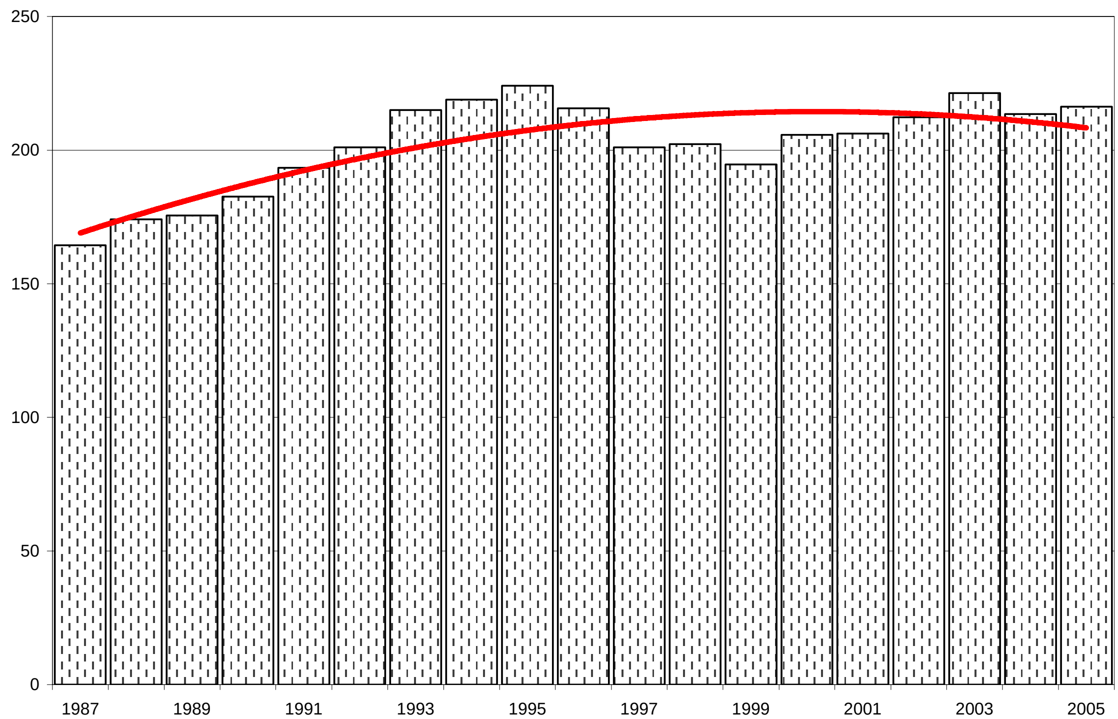
Economic and financial statistics of the FSM may present a mixed to favorable picture over the period when the economic provisions of the original Compact were in effect. However, the United States Government and American taxpayers can take satisfaction in the knowledge that the FSM, a political and economic entity made up of disparate peoples with distinct cultures, languages, and histories within small island communities, is an established, legitimate and dynamic democracy. Elections take place with citizen participation and tranquility. To the extent that democratic institutions and practices encourage transparency in government, direct involvement of citizens in their affairs and stability in the market place, the FSM is a reasonably stable and predictable market place. These attributes should make it possible to attract foreign resources other than U.S. Compact grants and other federal assistance.

As pointed out in last year's report, the initial stage of the implementation of the amended Compact was expected to boost the FSM economy in FY 2005. Based on data included in the FSM's FY 2004 Compact Annual Report that is required by the amended Compact (Section 215), the FSM GDP was an estimated $239.5 million in FY 2005, up 4.9 percent from a revised $228.3 million in 2004. Per capita GDP in the FSM was $2,211 in 2005, the highest recorded since the beginning of the Compact in 1986. This level of per capita national income would place the FSM at roughly at the same level as Papua New Guinea, Pakistan, Nicaragua and Iraq, for instance.

Looking at the period 1987–2004 as a way to assess the impact of the original Compact, it appears that although average by world standards, the FSM's overall economic performance was better than the average for most of the isolated and independent economies of the Pacific, which have generally stagnated or declined over the same period. Evidence of FSM's economic history suggests two distinct phases of economic change: (a) the growth and prosperity phase, roughly from 1987 to 1995, when real (adjusted for inflation) GDP grew every year, and (2) decline and stagnation phase, roughly from 1995 to 2004, when real GDP either declined or stagnated.

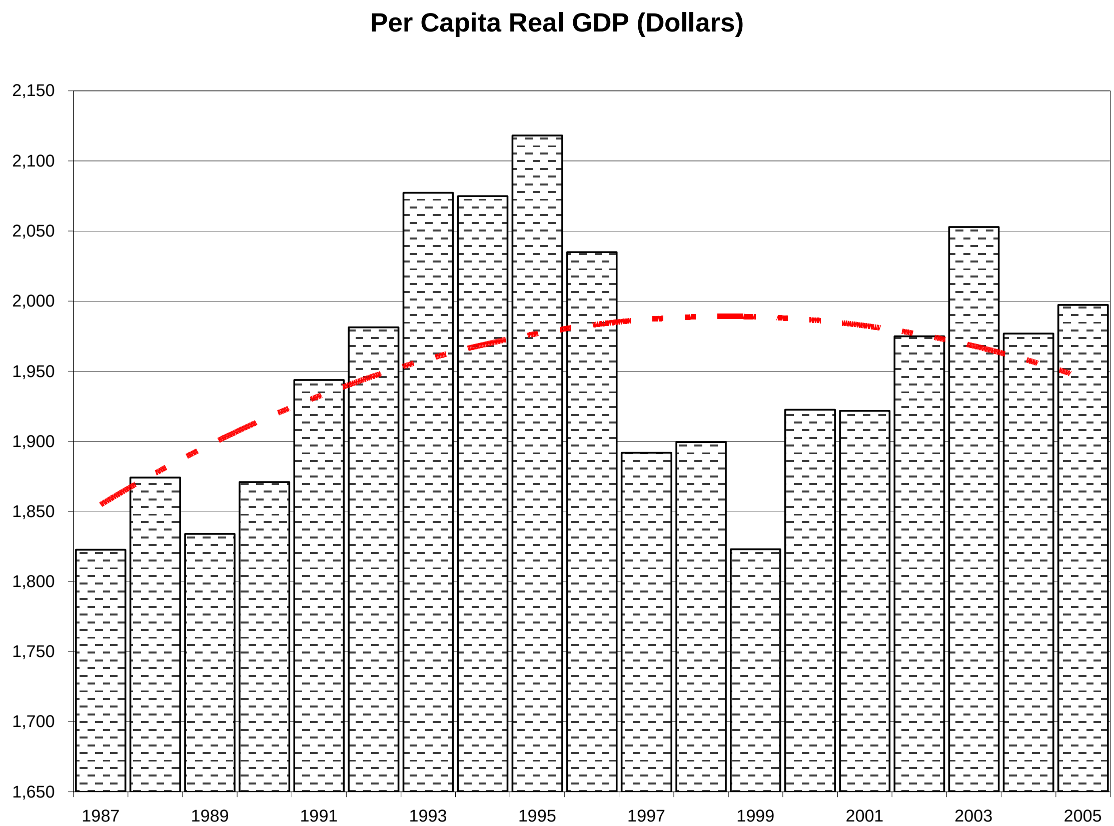
Beginning in 1987, real GDP grew every year through 1995, with the growth rate averaging 3.9 percent a year. That growth rate was higher than the average for the independent economies of the Pacific. Per capita real GDP, a measure of the average comparative standards of living, increased during six of the eight years, and its growth rate averaged roughly 1.9 percent annually in 1987–1995. To put it differently, the standard of living of the average FSM resident improved almost every year in 1987–1995, with the exceptions of small decreases in 1989 and 1994.

FSM's Real GDP
(Millions of 1998 Dollars)



In part, because of built in step-downs in Compact funding and, in part, because of factors such as lower than expected growth in the private sector, the economy took a turn for the worse in 1996 and continued to decline for four consecutive years. Real GDP declined in 1996-1999. As a result of this reversal of collective fortune, the FSM's real per capita GDP in 1999 was about where it had been in 1990. A strong but short-lived rebound occurred in 2000 when real GDP increased, only to be followed by smaller gains in 2001–2003. These gains elevated real GDP to where it had been in 1994, the year before the peak in the FSM's GDP. However, even with the growth in FY 2005, the FSM's real GDP was smaller in FY 2005 than it was in 1994 or 1995.

The decline and stagnation in the 1996–2004 period can also be seen in real per capita GDP. Real per capita GDP peaked at $2,118 in 1995 and declined or stagnated during most of 1996–2004, ending the period of the original Compact with a real per capita GDP of $1,977 in 2004. Although it rose to $1,997 in 2005, it remained notably below the previous peak. On a favorable note, total real GDP has increased steadily, although modestly, since 1999, and it appears to be on its way back to the mid-1990s level. If the amended Compact's provisions are accompanied by reforms in the institutional structure that would make the FSM a more attractive market, there is a good chance that the FSM's total output could surpass its previous peak.



During the 1987–2004 period, the FSM's consolidated government finances also reflected two phases, but they were not as clearly defined as they were with respect to total output. Given the peculiar nature of the FSM's financial structure, where most of the public sector funding has come from the Compact, it may have been expected that revenue and spending would have been more in line with each other and shown a more predictable pattern over the years.

Weak financial management, one of the dilemmas throughout the original Compact period, was only a part of the explanation. Uncertainty built into any financial management plan, regardless of the degree of competence of planners and governments, and the differences in practices and levels of competence within the four states have often spilled over to the national financial management scheme. However, it was mainly because of the weak financial management practices during the period of the original Compact that the amended Compacts incorporated more rigorous accountability measures. With control of the amended Compact funds allocation residing with the United States majority on the JEMCO, as opposed to the arrangement under the original Compact when the FSM government made both allocation and spending decisions, there is greater likelihood that financial management will improve. At the same time, transfer of allocation decisions to the United States majority on JEMCO has created a certain level of tension, especially in the FSM national government because this seen as loss of financial control. As both sides get accustomed to the new Compact regime, the tension is expected to dissipate.

The FSM's employment data tell a story that is in line with the economic and financial statistics. Total employment in the FSM increased every year, although sometimes by small increments, in 1987–1995. It rose from 12,209 to peak at 16,003. Beginning in 1996, total employment declined for three consecutive years, reaching a level it had been in 1991. Small gains followed in 1999–2002, but they turned into losses once again in 2003–2004. In 2004, total employment was where it had been in 1992–93. (No employment data are available for 2005.)

A significant change in employment during the 1987–2004 period was the decline in public administration (government) employment as a share of the total. In 1987, public administration accounted for 61.0 percent of the FSM's total employment. Even during the growth and prosperity period of 1987–1995, when both total output and employment increased, government's share of employment decreased steadily from 61.0 percent to 49.0 percent. Government's share of employment continued to decline through the economic decline and stagnation phase when it reached an all-time low of 42.7 percent in 2004. That employment continued to decline as a share of the total during the entire 1987–2004 period was a reflection of the realization that a bloated and inefficient public sector had to be brought in line with economic and financial realities. Still, government's share of employment is much larger than in most market economies, but not dissimilar from other U.S.-backed economies in the region where U.S. subsidy of the public sector has made it almost customary to depend on government as the ultimate provider of income and livelihood.

A critical and potentially highly destabilizing force in the FSM is the low ratio of formal employment to population. Only 13.5 percent of the population was employed in 1987, with employment being defined as work for pay. In 1995, the peak of the business cycle, this ratio rose to 15.1 percent, a record. In 2004, the ratio was 14.0 percent, not that much different from that in 1987.

By contrast, employment as a share of total population in the United States, for instance, was 47.3 percent in 2003 and averaged 47.2 percent over the 1990-2003 period. This is not to compare the population composition of the FSM, a small island economy nearly totally dependent on U.S. economic and financial support, to the United States, the world's largest and one of its most productive economies. However, it is to say that if such a small portion of an economy's population is engaged in formal employment, formal meaning work for pay, the burden on those who work to support the rest of the population would be so great that it practically prevents a steady increase in the average standard of living. The fact that only a small portion of the population can find gainful employment at home would naturally lead not only to unemployment and underemployment but emigration and displacement of families and communities.

It should also be pointed out that subsistence economy accounts for a relatively large part of the total economy, averaging 15.0 percent of GDP through 1987–2004, with small variations from year to year. Although there is no information on how to translate the market value of subsistence economy to formal employment, either in terms of employees or wages and salaries, it is safe to say that it accounts for a significant share of total output and the work that goes into it. Still, the ratio of formal employment to population is much lower than in most market economies.

Economic Reviews of the States of the FSM

Pohnpei, and to a lesser degree, Chuuk show patterns of economic growth similar to that of the FSM as a whole. Perhaps it may be more accurate to say that the FSM's economic performance in 1987–2004 was more a reflection of Pohnpei and Chuuk than that of all four states put together. Pohnpei, not only the most powerful state economically but also the seat of the national government, shows a pattern similar to that of FSM as a whole. Real GDP increased steadily from $67.7 million in 1987 to a record high of $106.7 million in 1995, but was down to $102.1 million in 2003 and slightly up again to an estimated $103.5 million in 2005.

Chuuk's real GDP increased steadily from $56.5 million in 1987 to $67.6 million in 1995. It contracted for three years thereafter until it began to rise again in 1999 and continued to regain some of the lost ground until it reached $63.3 million in 2003. In 2004, it was back down to $58.2 million and virtually unchanged at an estimated $58.3 million in 2005. The more notable point about Chuuk's real GDP is that it has yet to recover to the previous peak of 1995. Given the financial management problems that have plagued the State of Chuuk for years, including those at the beginning of the amended Compact's implementation, the prospect for a higher level of output and the associated lift in the average standard of living does not appear very bright.

Kosrae, the smallest state in terms of population, experienced growth in the 1987–1994 period, lost some ground in 1997–2000, but regained momentum earlier this decade to surpass the 1994 peak and reach a new high in 2003. However, it lost ground again in 2004 and even more in 2005 when it finished with a real GDP that was at the 1998 level.

Yap, the third largest of the four states in terms of population, had the most distinctive economic record in 1987–2004. Its real GDP was $24.2 million in 1987, $31.9 million in 1995, $37.4 million in 1998, but declined and remained flat in 1999-2002. In 2003, it was up to a record $38.1 million. It dropped to $36.7 million in 2004, but was estimated to be up to another record of $39.6 million. It is the only state of the FSM that showed relatively steady gain in real output during the entire 1987–2004 period.

Prospects for Private Sector and Economic Growth

Despite its increase as a share of GDP, which rose from 23.0 percent in 1987 to an estimated 29.6 percent in 2005, the FSM's private sector is a small piece of the economy. Since the days of the Trust Territory of the Pacific Islands (TTPI), the FSM private sector has been a secondary economic contributor with the public sector as the primary engine for sustenance. Unlike economies of the 50 States and others where the private enterprise drives the economy and supports a certain level of government, in the FSM, the public sector has thus far been the driving force. Although the public sector's share of the economy has declined over the last 18 years, government is still the driving force and will remain so unless major changes are made to alter this route into the economy of the future. It should be recognized, however, that market reforms to make the institutional structure more efficient and transparent, and improved infrastructure, would go only a certain distance. With physical realities remaining the same, regardless of the state of technology, expectations for private sector growth have to be adjusted to physical and institutional realities. Isolation, small mass, and limited land constrain the potential for most economic activities.

The FSM faces a fundamental challenge in that agriculture and farming holds extremely limited potential because of limited land and lack of other comparative advantages. Naturally, among the options to reduce pressures on the limited resources and fragile ecosystems in the islands is migration to the United States and its territories allowed under the original and amended Compacts. However, the migration provision does not suggest that everyone in the FSM would leave. A certain portion of the population will stay, regardless of social, economic and financial conditions in the FSM. And those who stay in the islands will still have families and the normal needs of families and communities. The key question is: for those who stay or cannot leave, what is the best path to a post-Compact economy that can reasonably offer both work and reward for those who will continue to call the FSM home. To put it differently, the question is: how does the FSM translate potentials in tourism and fishing and fisheries to output that would mean jobs, income and the tax base its government would need? Before specific proposals come to the fore, there are some basic infrastructure and financial issues that have to be considered.

Unlike large developing economies that can rely on loans in commercial markets as well as under preferential terms of global and regional lending institutions and other sources of funds in the global markets, the FSM is too small as an economy, as a regional power or source of future income to be an appealing client for global lenders. These disadvantages, however, do not mean that the needs of the FSM are different from those of large markets. The questions is: what can world and regional bodies do to increase the long-term productive capacities of small and isolated economies?

The answer lies in the type of infrastructure that will enable the FSM, for instance, to increase its productive capacity notably but does not have the indigenous financial resources with which to do this. The potential that adequate infrastructure may lead to greater production and distribution possibilities may be the argument that the FSM would take to world and regional bodies. The argument that adequate infrastructure creates a greater productive capacity may be presented to global and regional bodies such as the World Bank, the Asian Development Bank, individual governments such as Japan that may, in turn, consider the FSM for large infrastructure projects. Adequate infrastructure would make it possible to launch commercial tourism and generate more options for activities that would create greater levels of value-added in fishing and fisheries. To initiate projects of such a scale would require concrete proposals from the FSM that would demonstrate both the technological and financial feasibilities of greater output and, therefore, greater good.

For example, to bring large numbers of, say, Japanese tourists to the FSM to explore World War II wreckage sites, dive, undertake other recreational activities in the unspoiled waters of the Central Pacific, or engage in other activities on the ground would require, first and foremost, ground facilities that can accommodate wide-bodied jets. To extend the runway on the Island of Pohnpei, for example, would require large sums of money that can only be provided by regional and global assistance providers. To convince these bodies that they should invest large sums in small markets such as the FSM or its individual islands would require diligent work on what the possibilities are, how they are going to be exploited and how they are going to change productive capacity. In the FSM, tourism and fishing and fisheries are about the only realistic options at this stage for future traditional economic development. To haul large quantities of fresh fish from the region to Asian markets such as Japan would require not only runways and the associated facilities but commercial aircraft or other means of transport that carry large quantities of perishable products over long distances. To process some of the fish in the islands so some of the value added stays would require processing facilities.

As the experience of the last 50 years has shown, the physical realities of the region change very slowly, if ever. Meanwhile, population grows, as it does everywhere in the developing world, and puts more pressure on the fragile ecosystem. Since traditional methods of subsistence are inadequate to meet the needs of the 21st century consumers, new methods of expanding productive capacities have to be employed. In the small island nations of Micronesia, this means the type of infrastructure that would make it possible to create new income sources from within the existing living ecosystem. To make this happen would require not only the large sums of capital, but the full range of political, economic and financial cooperation of global and regional powers.

Taking steps to create the next economy of the FSM, and for that matter, of the Republic of the Marshall Islands (RMI) and the Republic of Palau (Palau) may require the direct involvement of not only regional and global institutions, but regional economic powers such as Japan. Engaging global and regional resource centers also falls within the scope and spirit of the FSM's own Strategic Development Plan (SDP) which is required by the amended Compact. Realization of the sustainable growth strategy, as outlined in the SDP, would require, more or less, the same infrastructure.

Prospects for Growth in Tourism

One industry that has played a critical role in increasing the private sector in small and isolated economies of the Pacific is tourism, especially in markets near main transport routes, such as Guam and Saipan. The FSM's tourism statistics reflect, quite realistically, the difficulties associated with small and remote markets, especially those with tourist facilities that are not considered regionally competitive.

Tourist traffic has been erratic and unpredictable in recent years. In 1996, total arrivals numbered 18,305, but dropped to 14,526 in 1998, the peak of the Asian financial crisis. Arrivals climbed back to 19,497 in 2000, reflecting the post crisis recovery in East Asia. They dropped again in 2001 to 15,884, perhaps because of the effects of the terrorist attacks on the United States, only to rise again to 18,301 in 2004 and an estimated 19,242 in 2005. What these numbers show, apart from the variations connected to regional economic and financial realities, is how small and unpredictable the FSM's tourism has been. (By comparison, Guam receives more than one million tourists a year, most of them from Japan.)

With the exception of Chuuk, which is just over an hour of flight from Guam, the other FSM states are off main regional transport routes. This makes it costly to fly to the islands and inter-island transport among the main inhabited islands is dependent upon a single commercial carrier. Moreover, tourism suffers from rudimentary facilities, even in the national capital on the Island of Pohnpei. The FSM still does not have a world-class hotel with meeting and other commercial facilities. Finally, tourism offerings are limited with few attractions for mainstream tourists. The market now focuses on adventure tourists, primarily divers and sport fishermen, from Asia and North America.

Business travelers provide another potential market. The Compact provides that, for purposes of Internal Revenue Code section 274(h)(3)(A), the FSM is included in the "North American Area" for purposes of the allowance of deductions for foreign conventions. Deductions for foreign conventions, meetings, or seminars are otherwise generally disallowed under the Internal Revenue Code, unlike events occurring in jurisdictions included in the "North American Area."

The question of whether tourists follow facilities or vice versa has been the topic of local discussion for decades. With the certainty of Compact funding, some would argue, there has been little financial incentive to create tourist facilities that would bring more affluent tourists and, therefore, more private activity to these islands. More study may be required on tourism to examine the issues of transport routes, the effects of new seating capacity, and the absence of tourist-class facilities. However, what is not in question any more is the long-term need to create an infrastructure that would make it possible to make use of the country's economic resources.

Migration from the Freely Associated States

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

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

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

Note: Enumeration of Micronesia migrants to Guam, the CNMI and Hawaii will be updated next in 2008, as required by the amended Compact.

As these numbers show, Micronesian migrants to the United States and its territories, although not a large number or a significant portion of all immigrants, are a large percent of the population of the area. The total of 20,808 is about 11.5 percent of the total population of the FSM, the RMI and Palau. Thus far, the bulk of the migrants are coming from the FSM, especially Chuuk; it is expected that future trends in Micronesian migration are likely to mirror the past.

The growing community of Micronesian migrants in the United States may result in certain advantages. First, those leaving Micronesia work in the United States and perhaps earn more than would be possible at home. Migration also reduces the pressure on fragile environments of the islands. Second, and more important, Micronesians working in the United States send money back home to support family and communities. Remittances from overseas may not be a large source of income at this point and there is no information to suggest its amount. However, as more Micronesians migrate to the United States and get established in their new communities, their remittance are expected to become an important future source of income that will contribute to economic growth and development for those who stay behind. The Compact obligates the governments of RMI and FSM to register all labor recruiters and require that they inform United States-bound FAS workers of their rights under United States law.

Republic of the Marshall Islands (RMI): Background

Just as in the case of the government of the FSM, the government of the RMI has not yet developed the capacity to generate and disseminate macroeconomic information. Basic statistics on the various components of the economy, the tax base, labor force, employment, wages and salaries, pensions and other commonly followed factors are being compiled and disseminated. World and regional organizations such as the International Monetary Fund (IMF) and the Asian Development Bank (ADB) produce their own assessments of economic growth and development conditions through field visits to the country. This report is based mainly on the Annual Compact Report for Fiscal Year 2004, submitted by the RMI Government, and subsequent preliminary national income account data which have only recently been developed.

A succession of foreign advisors, including teams funded by the ADB and the United Nations Development Program, has been employed over the years to generate and disseminate macroeconomic data and offer economic and financial advice to the national government. Despite good work by outside entities, the skills to do this work have rarely been effectively transferred to the RMI government staff who could continue this work independently. In its current stage of engagement, the ADB has had technical assistance grants to strengthen the RMI's Economic Policy, Planning and Statistics Office (EPPSO), which is a part of the Office of the Chief Secretary which, in turn, is a part of the Office of the President. The rationale behind attaching EPPSO to the Office of the President of the RMI is to make it more visible and perhaps a more viable organization to monitor economic progress, make policy and report its findings.

Institutionalizing the efforts to produce economic and financial data and policy advice requires time and permanent commitment of resources for which the amended Compact makes certain provisions. Meanwhile, both the RMI and United States governments are required to report on the RMI's progress every year through 2023. Assistance for moving more rapidly toward self-reliance in economic and financial data and policy analysis and advice may be found within the amended Compact's provision for capacity building. Putting those resources together with those from others, such as the ADB, would make it possible to establish a collaborative mechanism and fund it consistently. As this effort progresses and becomes a part of the institutional structure, it would make economic and financial data a part of the public good that the government of the RMI offers its citizens and others.

The amended Compact with the RMI provides for a certain level of economic and financial aid every year (through FY 2023), as did the first one, but places greater and more explicit emphasis than did the original Compact on expanding the productive capacity of the economy in an orderly manner (through FY 2023). This is to take place through improvements in public health, public education, public infrastructure, capacity building and other aspects such as institutional reforms that would make the RMI a more attractive market to overseas capital and skills. Public Law 108-188 section 140(h)(1) requires this annual economic and financial report on the RMI by the United States Government. This report will give the Congress information on, among other things, the use and effectiveness of United States financial, program, and technical assistance; the status of economic policy reforms; and the status of the efforts to increase investment.

Unlike the first Compact, the amended agreement provides for the creation of a trust fund for the people of the RMI that, if maintained with the prudence that successful public trust funds require, will generate a reliable income stream after 2023. Starting in 2005, both the United States and the RMI deposit annually certain amounts into the trust fund until 2023. Over the 20-year period ending in 2023, the trust fund will have accumulated a reserve of sufficient level that would generate interest income to replace the operational (sector) grant payments from the United States. To express this differently, interest income from the trust fund is expected to replace U.S. sector grants and offer the RMI Government a reliable source of income and greater degree over its disposition.

Since the total U.S. sector grant drops by a certain amount every year until 2023, with the amount of reduction going into the trust fund, the operating grant will be smaller every year, making it more likely that the interest income from the trust fund will be sufficient to replace direct U.S. payments. To compensate for the operational (sector) grant reduction every year until 2023, the RMI government will have to make the necessary adjustments in its budget proposals to the Joint Economic Management and Financial Accountability Committee (JEMFAC). Alternatively, the RMI government may find other sources of income such as taxes and fees to make up for the decrements in the operating grants from the United States. With 18 years of reliable operational grant and trust fund deposits, the amended Compact provides the people of the RMI a horizon of sufficient length in which to plan and map out the post-Compact phase of their economic and financial destiny.

The year 2023 may appear so far in the future as to give political and traditional leaders in the RMI a false sense of comfort and security. However, long-term viability of the RMI economy beyond a steady flow of U.S. assistance (Compact grants and other federal aid) would require the hard work ahead to start immediately. This would entail identifying those areas of the economy, current and future, where scarce resources would be best invested. With those areas of the economy that would require development policies and investment plans, the RMI leadership would then start the search for resources that would make it possible to move toward a more self-sufficient economy. The main objective of this plan would be to steer the RMI economy toward a sustainable standard of living for the entire population beyond the Compact.

The resources to make prosperity possible in the post-Compact era may come from global and regional assistance providers such as the World Bank, the Asian Development Bank, other bi- and multilateral agencies and governments in the Asia-Pacific region such as Japan and Taiwan which already provide a significant amount of assistance to the region. To secure funds of a certain level from these providers that would make a difference in the RMI economy, especially in its small and remote atolls and islands, the work has to begin now, and an important part of that work has to be continued assessment of what the economy's productive capacity is, how it performs and what its best future can be.

A unique aspect of the RMI's economy is the strategic link between the United States and the people of the Marshall Islands, namely the Ronald Reagan Ballistic Missile Defense Test Site (Reagan Test Site, RTS) and other military facilities situated on Kwajalein Atoll. To the extent that the U.S. military remains engaged in activities that benefit from infrastructure on Kwajalein, it is a source of income to the RMI that would be hard to replace, especially quickly, with civilian ventures. The sense of certainty arising from the U.S. military's engagement on Kwajalein is a positive factor in the economic and financial affairs of the Marshall Islands. However, whether there is a long-term time table attached to it is hard to discern. The military may be engaged in the RMI for years, possibly decades, but that should not prevent the RMI government from pursuing alternative non-military means by which to increase the economy's productive capacity, employment and the tax base.

Blending Democratic Institutions with Tradition

Economic and financial reviews of the RMI may reveal a challenging picture in the years 1986–2004 when the economic provisions of the original Compact were in effect. However, the United States Government and American taxpayers can take a great deal of satisfaction in the knowledge that the RMI is a vibrant democracy. The original Compact was designed to build on and institutionalize a representative self-governance system that had begun to take shape during the United Nations Trust Territory of the Pacific Islands in the 1950s-1970s, which the United States administered. Democracy has flourished in the RMI, despite the challenges of a hierarchical traditional social structure, small atolls and islands with scattered populations, and few resources other than the Pacific Ocean. National and local elections take place with citizen participation and tranquility.

The enduring legacy of United States involvement in the RMI and, for that matter, in the rest of Micronesia, has involved the blending of local traditions and cultures with modern democratic institutions and practices. The RMI's political system generates the political and social stability within which the Marshallese, their institutions and markets can work to achieve a greater degree of prosperity. Using democracy to heighten prosperity is a challenge in the small, isolated, and traditional markets of the Central Pacific, but one which the people of the RMI, with United States support under the Compact, are on track to achieve.

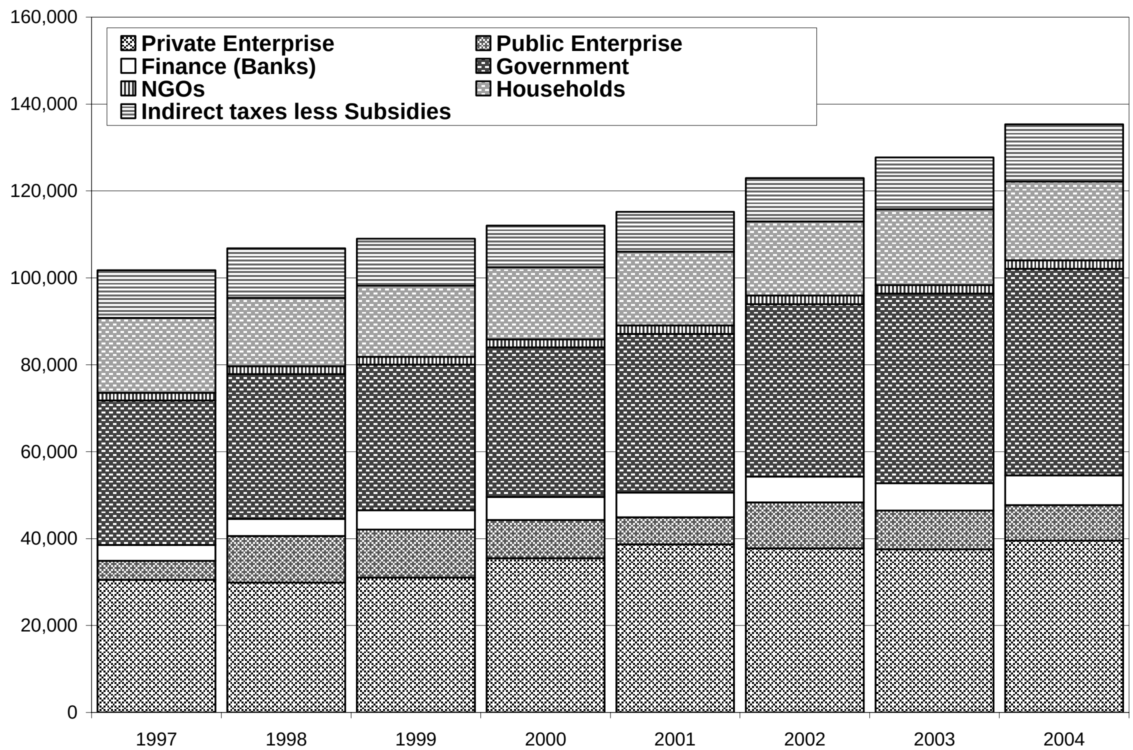
Economic and Financial Review

Among the new developments in the early stages of the amended Compact is the RMI's capacity to generate its own national income and product accounts, with the supervision and technical assistance of the Asian Development Bank (ADB). Generated by the RMI's Economic Policy, Planning and Statistics Office (EPPSO, these numbers point to a pattern that appears to be quite different from that suggested by data recently cited by others. For example, in a report following its "Article IV" consultations and economic and financial review of the RMI in early 2004, the International Monetary Fund (IFM) reported the following:

> During 1995–2001 (the latest official data), real GDP and real per capita GDP contracted by nearly 25 percent and 35 percent, respectively. Employment has not increased since the late 1980s. Between 1988 and 1999, the unemployment rate jumped from 12 percent to over 30 percent and is estimated to have remained broadly unchanged.[1]

In contrast to these numbers, RMI's gross domestic product (GDP) data generated by EPPSO show that total real (adjusted for inflation) GDP increased 22.6 percent from $101.8 million in 1997 to $124.7 million in 2004, the period for which these data have been generated. Based on these data, real GDP increased an average of 3.0 percent a year in 1997-2004. Although the time period included in the IMF report and that for which EPPSO has calculated GDP are not identical, the contrast these two sets of numbers offer appears stark. However, since EPPSO has generated these data from sources that are believed to be credible and used standard methodology, these numbers have to be taken as representation of economic reality, unless evidence to the contrary comes to the fore.

GDP by Institutional Sectors (Thousands of Dollars)



[1] International Monetary Fund, "IMF Concludes 2003 Article IV Consultation with the Republic of the Marshall Islands," Public Information Notice (PIN) No. 04/8, February 13, 2004.

Based on the new GDP data, the RMI economy exhibited a much healthier performance, especially in 2002-2004, when real GDP increase averaged 5.3 percent. The 2002-2004 rate of growth in total output was in sharp contrast to the 1997-2001 period when the gain in real GDP averaged 1.2 percent. The question is: what caused the rapid growth rate in 2002-2004? Some of the financial impact of the amended Compact's launch stage in 2004 has been cited as a part of the explanation.

There is also some evidence in the RMI employment data that suggests a stronger economy than cited in previous reports. According to EPPSO, total employment increased steadily between 1997 and 2004. In FY 1997, total employment was reported to be 7,506, based on the RMI Social Security Administration data which includes only those employees who would pay into the social security system. This total normally excludes self-employed and sometimes part-time employees who do not contribute to and receive benefits from formal, employer-provided pension programs. In 2004, total employment stood at 9,161, 22.0 percent higher than the 1997 level. Again, these data suggest a different picture than that offered by data cited by the IMF and others.

Average annual earning figures also show improvement, but it has been rather uneven. In 1997-98, the average annual earnings were just over $8,258. In 1999-2003, they averaged $8,549, but in 2004, they rose a healthy 6.2 percent to $9,003, the highest for the period in question. The increase in the average annual earnings in 2004 can be attributable largely to the rise in the annual earnings in government, foreign embassies and the Kwajalein base. The RMI government annual average earnings were up 17.2 percent in 2004 from 2003. Foreign embassy earnings were up 15.9 percent and Kwajalein base earnings were up 14.6 percent. By contrast, average annual earnings in the private sector as a whole were down 0.9 percent. They were down even more, 1.8 percent, in banks.

Over the entire 1997-2004 period, the average annual earnings that showed the most gain were in the RMI government, up 46.0 percent, followed by government agencies with 27.9 percent, foreign embassies with 23.3 percent and the Kwajalein Base with 18.8 percent. Private sector average annual earnings in 1997-2004 were down 18.3 percent, followed by a 2.7 percent loss in local government. The RMI average for the 1997-2004 period showed an increase of 8.8 percent.

This state of the economy is the product of a unique set of circumstances. The RMI relies heavily on external flows of funds, (Compact and others from the United States, and some from other countries and global institutions). Since these sources generally enter the economy, through government services, they naturally show their impacts in the public sector data. Even then, the large decrease in private sector average annual earnings between 1997 and 2004 suggests considerable contraction. The important question now is whether the private sector will recover and if so, what it would take.

Since this report was compiled, the fish processing plant, the largest private sector employer in the RMI, which employed 500–600 persons at its peak, has been closed. When the plant opened earlier in the decade, it was the first major commercial enterprise to take advantage of the RMI's abundant fish resources. The closing of the fish processing plant was among the most significant adverse developments in the Marshall Islands in recent years.

Economic and Financial Outlook

The average elevation from sea level in the Marshall Islands is about seven feet and most of the soil of the relatively flat atolls and islands is too salty to produce much food and fiber. Tropical crops and trees that have adapted to the salty soils, such as coconut palms, do not produce much economic value to compete with jobs in the money economy. These realities severely limit production in traditional agriculture.

Given these constraints, the RMI should focus on encouraging the return to growth in the RMI's fishing and fish processing. The Marshall Islands and other Pacific economies have been selling fishing rights to foreign fleets for decades, but those rights generate modest sums of money and almost no local value added other than purchase of local fuel and supplies. The loining plant in Majuro generated local value added in wages and salaries and other benefits that go with formal work for pay. Its demise raises serious questions about the RMI's ability to benefit from its most abundant natural resource.

Production of Copra, the dried white flesh of a coconut, continues, although its share would most likely decline as other activities present more attractive options, especially to those with education and skills.

Tourism represents a possibility for new growth. Specialized tourists such as divers, sport fishing enthusiasts, and others who normally travel in small groups but have more money to spend per person per trip, represent a potentially lucrative market. Business travelers provide another potential market. The Compact provides that, for purposes of Internal Revenue Code section 274(h)(3)(A), the RMI is included in the "North American Area" for purposes of the allowance of deductions for foreign conventions. Deductions for foreign conventions, meetings, or seminars are otherwise generally disallowed under the Internal Revenue Code, unlike events occurring in jurisdictions included in the "North American Area."

Among the RMI's most valuable physical assets are its location and strategic ties to the United States. The RMI's contribution to United States strategic assets and facilities is a valuable comparative economic and strategic advantage that has been successfully translated into a reliable income stream. The amended Compact offers an additional significant advantage to RMI citizens, the right to travel to and reside in the United States. Also, more islanders living in the United States can be a valuable source of income as they send money home to relatives.

The United States hopes to contribute to economic and financial stability through the amended Compact with the RMI. With upgrades to its institutional structure, including the provision of current and reliable economic and financial data, the RMI economy could show growth going forward.

With stringent financial resource allocation controls written into the amended Compact, the RMI's financial situation has the potential to improve and the RMI government has made financial stability a major objective under the amended Compact. For instance, the Joint Economic Management and Financial Accountability Committee, on which the United States has the majority vote, can play an instrumental role in both allocating and managing United States assistance in a manner that reduces misallocation and mismanagement. With financial controls in place, it is expected that increased benefit from Compact funds will accrue to the people of the Marshall Islands over the next 18 years.

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

The FSM and the RMI receive significant financial, program, and technical assistance support from the United States Government. The amended Compacts provide the largest proportion of assistance through sector grants, trust fund transfers and other support, but the two governments also receive annual program support from a variety of Federal sources. In addition to administering Compact funds, the United States Department of the Interior continues to provide discretionary grants for technical assistance, operations and maintenance of public infrastructure, and to protect coral reefs. Although the Supplemental Education Grant (SEG) created by the Compacts now includes most of the Federal financial support formerly received from program grants of the United States Department of Education and Labor, and about half of the support formerly received from the United States Department of Health and Human Services, other Federal agencies still support the FASs.

Compact Sector Grants

In FY 2005, the United States Department of the Interior managed \$95,379,791 in Compact sector grant funds. Of that total, the RMI received an inflation-adjusted amount of \$19,379,781. The FSM deferred its inflation adjustment until FY 2006, and agreed to an allotment of \$76,000,000 in grant funds only.

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

> **Education:** The intent of the education sector grants is to support and improve the primary, secondary, and postsecondary education systems of the governments and develop the human and material resources necessary to perform these services. The amended Compacts requires that funding use emphasize: (1) the

advancement of a quality basic education system by increasing primary and secondary student achievement as measured by performance standards and assessments appropriate to the two countries; (2) the provision of secondary education or vocational training to qualified students; (3) the improvement of management and accountability within the educational systems; and (4) raising the level of staff quality; and improving the relevance of education to the needs of the economy.

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

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

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

Public Sector Capacity Building: Public sector capacity building grants are to support efforts to build effective, accountable, and transparent national and local governments and other public sector institutions and systems. Funding priorities are to improve economic planning, financial management, auditing, law enforcement, immigration controls, the judiciary, and the compilation and analysis of appropriate statistical indicators. The goal is to ensure that both governments have the means to carry out essential functions and fill essential positions with qualified personnel.

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

Although appropriated in FY 2005, additional funding for both countries only became available for use late in the year in the form of a Supplemental Education Grant (SEG). This money is in lieu of certain grants previously awarded by the United States Departments of Labor, Health and Human Services and Education, and supports the educational objectives of each government's Development Plan. Different from sector grant funds, the SEG is subject to annual appropriation. This adjunctive grant does not supplant basic sector grant funding; nor does it satisfy the priorities mandated by the amended Compacts. FY 2006 will mark the first full year of grant funding.

FY 2005 Sector Allocations for the FSM and Uses

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

	Education	**Health**	**Capacity Building**	**Private Sector**	**Environ-ment**	**Infra-structure**
National	4,511,317	763,235	608,028	-0-	111,421	No allocation
Chuuk	8,804,369	5,595,636	3,001,410	1,403,876	502,499	No allocation
Kosrae	2,070,432	1,674,212	1,113,866	988,025	296,592	No allocation
Pohnpei	7,469,772	6,200,560	1,542,488	657,602	688,181	No allocation
Yap	4,249,157	3,197,090	1,520,446	989,407	791,258	No allocation
Total	27,105,047	17,430,733	7,786,238	4,038,910	2,389,951	17,249,121

HEALTH SECTOR

Government	Funds Allocated	Funds Used
National	763,235.00	723,997.38
Chuuk	5,595,636.00	5,501,333.00
Kosrae	1,674,212.00	1,592,223.49
Pohnpei	6,200,560.00	599,5396.00
Yap	3,197,090.00	2,999,507.00
Total	17,430,733.00	16,812,456.87

EDUCATION SECTOR

Government	Funds Allocated	Funds Used
National	4,511,317.00	4,482,336.31
Chuuk	8,804,369.00	7,497,885.00
Kosrae	2,070,432.00	2,070,432.00
Pohnpei	7,469,772.00	7,154,734.00
Yap	4,249,157.00	4,034,959.50
Total	27,105,047.00	25,240,346.81

PUBLIC SECTOR CAPACITY BUILDING SECTOR

Government	Funds Allocated	Funds Used
National	608,028.00	495,362.20
Chuuk	3,001,410.00	2,895,039.00
Kosrae	1,113,866.00	1,067,710.76
Pohnpei	1,542,488.00	1,422,284.00
Yap	1,520,446.00	1,217,442.00
Total	7,786,238.00	7,097,837.96

PRIVATE SECTOR DEVELOPMENT

Government	Funds Allocated	Funds Used
National	0.00	0
Chuuk	1,403,876.00	1,357,764.00
Kosrae	988,025.00	869,004.08
Pohnpei	657,602.00	656,496.00
Yap	989,407.00	878,717.00
Total	4,038,910.00	3,761,981.08

ENVIRONMENT SECTOR

Government	Funds Allocated	Funds Used
National	111,421.00	0.00
Chuuk	502,499.00	463,328.00
Kosrae	296,592.00	286,791.24
Pohnpei	688,181.00	669,908.00
Yap	791,258.00	615,703.00
Total	2,389,951.00	2,035,730.24

Education

Most FSM states identified the following common goals:

1. The establishment of quality early childhood education programs;
2. The provision of quality elementary and secondary education programs;
3. The offering of relevant vocational education programs; and
4. The support of post-secondary education students and programs.

Education personnel proposed revisiting the FSM Strategic Development Plan's goals for education to ensure a better alignment with state objectives and nationwide conformity.

The FSM spent an average of $707 of its Compact sector grant allocation for FY 2005 on each student. The data show a wide range of per capita expenditures, from a low of $526 per student in Chuuk to a high of $1,525 in Yap:

		FY 2004		FY 2005	
Govt.	Sector	Reported expenditure	Per capita expenditure[2]	Reported expenditure	Per capita expenditure[3]
Kosrae	Education	$1,883,853	$768	$2,070,432	$842
Chuuk	Education	$7,384,265	$520	$7,497,885	$526
Pohnpei	Education	$7,140,221	$715	$7,154,734	$715
Yap	Education	$2,883,924	$1,092	$4,034,959	$1,525
		$19,292,263	$659	$20,758,010	$707

Education continued to be one of two Compact sectors that provided baseline data. The indicators of educational performance allowed annual comparisons among the four states. Over time, a quantifiable determination of progress and nationwide trends will be possible.

The FSM National Division of Education continued to focus on high school accreditation, using criteria of the Western Association of Schools and Colleges, and sought input and endorsement of a proposed, national education strategic plan. In Chuuk, potential mismanagement of funds for a secondary student nutrition program initiated a nine-month investigation, during which time Compact funding for that activity was suspended. The probe into Chuuk education resulted in the system-wide Chuuk Education Reform Plan. Several objectives of the plan were met by the close of FY 2005, such as developing clear guidelines for operating the student nutrition program on a

[2] The calculation uses a population of 108,031. The estimate applies a 0.24 percent growth rate to FSM's 2000 Census data (FSM National Government, Department of Economic Affairs).
[3] The FSM's four state departments of education provided public school enrollment data for the school year 2004/2005 to the Honolulu Field Office. This information serves as the basis for calculating per capita expenditures.

smaller scale, and removing non-working educational staff from payroll.

Kosrae maintained its focus on teacher certification; fewer than 10 percent of their teachers now lack a minimum AA or AS degree. Pohnpei developed and instituted a structured leadership training program for school principals and continued to enforce a mandate that all teachers must pursue a BA in education degree. One year after typhoon Sudal struck Yap in April 2004, repairs to all schools and administrative offices were complete. Damaged computers, textbooks and related curricular materials remain in short supply.

Supplemental Education Grant (SEG) funding to the FSM arrived late in the fiscal year. The funds supplement the activities of the four goals cited above.

Health

For FY 2005, the FSM received a health sector grant of $17,430,733. This amount represented an overall increase of 12 percent over the previous year's allocation, but there was a much wider percentage spread among the five government entities that received allotments: Chuuk State, 19.3 percent; Kosrae State, 26.2 percent; FSM National Government, 37.9 percent; Pohnpei State, 3.5 percent; and Yap State, 23.8 percent. The variability arose from competing financial support needs within the states and different budget formulation policies and priorities, and did not translate into more health care improvements in the states that received proportionately higher grant funding.

FY 2005 per capita expenditures for health, while increased over FY 2004 levels, reflected the disparity of Compact funding allocation within and between the states:

		FY 2004		FY 2005	
Govt.	Sector	Reported expenditure	Per capita expenditure	Reported expenditure	Per capita expenditure
Kosrae	Health	$1,326,663	$166	$1,592,223	$199
Chuuk	Health	$4,303,076	$80	$5,501,333	$102
Pohnpei	Health	$5,350,247	$153	$5,995,396	$171
Yap	Health	$1,821,873	$162	$2,999,507	$266
		$12,801,859	$118	$16,088,459	$148

As was the case in FY 2004, the health sector grant again primarily supported regular recurring operations. It also enabled long-neglected salary adjustments for some categories of health professionals, supported tertiary medical referral management and care; and provided resources to hire staff to expand in- and out-patient service capacity and perform minor repairs. For the hospitals, direct assistance enabled the improvement of supply inventories that alleviated chronic shortages and the restoration of at least minimally adequate diagnostic capacity. However, lacking reliable inventory systems, procurement procedures, willing vendors, equipment maintenance and recruitment methods, these facilities still risk deterioration.

Without an accurate accounting of health revenues from the FSM, it is impossible to determine the extent to which Compact dollars supported FSM's sector in FY 2005. However, it is clear that none of the four states allocated general revenues to the sector and that Compact assistance alone supported their operating budgets. Other revenue sources included U.S. Federal grants primarily for public health and prevention; the basic social services loan from the Asian Development Bank; targeted foreign assistance; health insurance reimbursement and/or capitation; and nominal service fees.

Despite the FSM Strategic Development Plan's espoused emphasis on primary health care, funding continued to follow the path of curative care. This was, in large measure, due to a continuing need to play "catch up" to normalize those services and programs that were adversely affected during the step down phase of the Compact's first financial assistance period.

The overall impact of these service and organizational enhancements over the medium and longer term continues to depend on the safety and adequacy of the sector's physical infrastructure. Facility repair, renovation, and construction that needed redress years ago are still issues. The likelihood of health projects receiving expedited attention and priority is marginal.

Public health and primary care received comparatively less attention, even though the population of the FSM is far-flung and still vulnerable to both infectious and debilitating chronic disease. Chuuk's dispensary program evidenced severe problems in maintaining adequate drug and supply stocks; supervising health assistant performance and attendance; up-keep and repair of facilities; supporting transportation; and communicating with the outer islands. This situation prompted the reprogramming of Compact sector grant funds to begin redressing some of the more urgent needs. Issues relating to the delivery of primary health care to remote populations, however, were not just isolated to Chuuk. An evaluation of dispensaries required by JEMCO revealed the other FSM states had the same problems, prompting JEMCO to recommend closer monitoring of the FSM's FY 2007 budget formulation and execution activities to link financial assistance to the country's strategic goal of improved primary health care.

Public Infrastructure

In addition to over $17 million of unused public infrastructure funding carried-over from FY 2004, JEMCO allocated another $17 million for infrastructure improvements and maintenance in the FSM in FY 2005. At the time that funding was allocated in August 2004, JEMCO had not concurred with FSM's Infrastructure Development Plan. The concurrence came on March 11, 2005, during a special JEMCO meeting but only insofar as the plan involved the use of Compact infrastructure sector funds for projects within the priorities established in the Fiscal Procedures Agreement.

In May 2005, the FSM National Government signed a contract with a professional architectural and engineering design firm to provide the FSM with expertise in managing the formulation and implementation of Compact funded infrastructure projects. In late May, OIA granted $34,368,276 to the FSM for the Public Infrastructure sector grant. Once again, due to internal differences between the FSM National Government and the state governments regarding the process of project implementation and the inability to demonstrate how the funding will be managed in a unified comprehensive method, no funds were approved for expenditure in FY 2005. The entire un-obligated balance remains available, in addition to the funds provided for infrastructure in FY 2006.

Public Sector Capacity Building

The FSM received $11,662,846 for the capacity building sector, an amount that represented 15.4 percent of all direct financial assistance for FY 2004. This was a proportionately larger amount than intended or foreseen by the negotiators of the amended Compact but necessitated by the FSM's apparent lack of local revenue to cover a range of government operations. From the outset, under the amended Compact, the U.S. delegates to JEMCO made clear that the purpose of this grant was to *build* capacity in certain key functional areas, such as accounting, financial management, budgeting, auditing, and law enforcement. They were concerned about the possibility that the grant might be used to maintain pre-existing capacity, or, worse, that it might be used as a general operating subsidy for government.

Notwithstanding the foregoing concerns, all parties recognized that the FSM did not initially have sufficient local revenue to support certain key public sector functions, and that preventing the FSM from using public sector capacity grant money to fund pre-existing operating expenses might result in a reduction in capacity in crucial areas. JEMCO agreed to allow certain pre-existing operating expenses in core functional areas to be initially funded from the public sector capacity building grant subject to a 5-year phase-out period.

To date the FSM has maintained its targeted phase-out schedule. The grant for FY 05 was $7,786,238. Although the grant supported a sprinkling of true capacity building initiatives, these uses have not been well articulated by the FSM states and there is no short-term or medium-term plan to guide how the sector grant should be best used.

Environment

The FSM received an allocation of $2,389,951 for its environment sector. The grant continued to fund government operations rather than environmental projects. Each State received funding for an Environmental Protection Agency or similar agency with a like mission. Financial assistance also supported marine and forestry conservation efforts. Public education programs were a part of all programs funded under this sector.

The lack of national goals for the environment sector continued to hamper the evaluation of performance progress. Each State established its own strategic focus at the agency or office level and activities failed to roll up to overarching national goals for the sector. However, most program officials agree that the top three environmental concerns in the FSM are drinking water quality, wastewater management, and solid waste control. Conservation and resource management activities are also considered priorities by program officials. In the coming year, the FSM will focus on developing performance measures to reflect national environmental priorities.

Private Sector Development

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

The FSM continues to lack national performance goals for the private sector development grant and this affected the ability to assess progress over the grant year. Each State established its own strategic focus at the agency level and reported on activities that failed to roll up to overarching, national goals for the sector. For the most part, it was difficult to gauge performance, but there were major accomplishments within each funded agency. For example, the Chuuk Small Business Development Center conducted over 120 counseling and training sessions with small business owners and also helped business owners to secure over $175,000 in loans. The Pohnpei Visitor's Bureau helped coordinate tourism activities on the island for the crew of the U.S. Navy Fitzgerald.

During the next fiscal year, the FSM will work to develop sector-wide goals. It is expected that this activity will assist the FSM to develop a budget that more closely reflects the intended objectives for private sector development.

Fiscal Year 2005 Allocations for the RMI and Uses

The following is a breakdown of grant allocations to the RMI by sector and a listing and distribution of public sector infrastructure project funding:

RMI SECTOR GRANTS (Operational)

Sector	Funds Allocated	Funds Used
Education	$11,566,921	$11,566,921
Health	$7,064,197	$7,064,197
Environment	$404,720	$374,792
Private Sector	$361,943	$326,794
Capacity Building	$103,514	$61,764
Total	$19,397,781	$19,332,704

PUBLIC SECTOR INFRASTRUCTURE GRANTS

FY 04	Amount	Balance
Jaluit H.S Phase 1	$3,710,270	$2,658,173
NIHS	$1,405,000	$678,551
Rita Phase 1	$1,200,000	$50,336
MIHS	$1,832,500	$1,174,655
Laura HS	$760,125	$241,998
Majuro hospital equipment	$827,410	$20,225
OI dispensaries	$490,000	$431,595
Ebeye Hospital equipment	$570,000	$489,001
Ebeye professional housing	$429,671	$399,222
Ebeye Power and Water	$350,000	$0
CMI capital improvements	$139,888	$12,364
CMI info network	$184,506	$15,004
Maintenance Fund	$700,000	$0
	$12,599,370	$6,171,124
FY 05		
Rita Phase 2	$1,210,000	$1,133,726
Uliga Elementary School	$3,695,732	$3,695,732
Marshall Islands H.S.	$4,700,000	$4,583,524
Ebeye Elementary School	$1,088,750	$1,088,750
Maintenance Fund	$674,287	$0
Majuro Hospital Equipment	$1,071,127	$567,710
Ebeye Sewer	$288,710	$0
Ebeye Water	$100,000	$0
	$12,828,606	$11,069,442
CSG-RMI-2005-INF-REPROG		
Majuro Airport Repaving	$500,000	$500,000
Namdrik School Phase 1	$1,000,000	$1,000,000
Majuro Solid Waste	$250,000	$250,000
Education Maintenance	$507,769	$507,769
KAJUR RO Unit	$45,000	$45,000
KAJUR Building	$80,000	$80,000
KAJUR Generator Overhaul	$200,000	$0
KAJUR Guggeegue Underground Power	$175,000	$175,000
	$2,757,769	$2,557,769

Using the 2004 population estimate from the RMI's 1999 Census, the Marshall Islands spent a total of $132 of its Compact health dollars on each person in 2005 and for infrastructure, $285 per person. The per capita spending on education was $1,031.[4]

[4] Education per capita expenditure data is from public primary and secondary school enrollment data for the school year 2003-2004. During that year, the schools enrolled 9,889 students.

Education

During FY 2005, the RMI used Compact funds to meet the following seven key goals:

1. Increase the number of early childhood enrollees;
2. Establish a quality primary education system;
3. Promote school attendance by all students;
4. Provide a quality secondary education system;
5. Increase success rates among post-secondary students;
6. Provide scholarships to qualified students; and
7. Improve the coordination between schools and vocational education.

The RMI Ministry of Education (MOE) continued the second year of universal kindergarten classes. New and current K coaches and teachers received additional training on teaching skills, especially literacy skills, e.g., phonics. The MOE continued training all elementary teachers on language arts and math performance standards. The standards served as the basis for creating a national test for 8th graders. Two task forces were created to address teacher absenteeism and student truancy. A textbook committee was established to improve the evaluation and selection of textbooks and other curricular materials. The first-ever test of English language literacy was given to over 1,000 teachers, 63 percent of whom failed. Summer intensive English language institutes were held and the College of the Marshall Islands (CMI) is offering ongoing English literacy courses to MOE staff. At the close of School Year 2004-05, the MOE submitted baseline data on 17 indicators of educational performance that will be collected and compared annually.

The CMI continued its slow, steady progress toward meeting significant accreditation issues of the Western Association of Schools and Colleges (WASC). While not yet off "show cause" status, WASC allowed an unprecedented two additional 6-month extensions, showing evidence of their recognition that improvements are underway. In addition to revising all academic programs, completing phase 1 of a facilities master plan, making significant facilities repairs, establishing three student computer labs, and revising staff hiring and retention policies, CMI also hired a new college president.

FY 2005 SEG funding to the RMI contributed to the seven goals cited. The grant award was released late in the fiscal year due to logistics issues regarding the transfer of funds from the U.S. Department of Education to the Department of the Interior.

Health

The Ministry of Health received an allocation for FY 2005 that was approximately $1 million less than the previous year. The smaller $4,887,889 sector level proposed by the Government of the RMI, was a major contributor to the modest 25 percent increase in the health budget (all revenue sources combined) since targeted financial assistance began under the amended Compact.

Compact funds provided approximately 40 percent of the total dollars available for health care. Although primary health care is the focus of the Ministry's strategic mission and viewed as the principal means to improve health status, funding has not followed policy. In FY 2005, hospital-based outlays continued to outpace those for public health, prevention, and outer island primary care services because of the need to improve hospital operations and diagnostic and treatment capacities to decrease the reliance on tertiary medical referrals. The RMI targeted an additional $2,894,500 in infrastructure funding for equipment purchases for Majuro and Ebeye hospitals, facilities maintenance, and dispensary renovation.

The findings of a comprehensive assessment of the dispensary system that JEMFAC required in FY 2005 also emphasize the disparity between policy and budget priorities. Transportation and communication problems and shortfalls in staffing, equipment, pharmaceuticals, supplies, and facility maintenance were commonplace before the amended Compact period began, and continue to be issues. Only 45 of the RMI's 62 health centers and dispensaries were open in FY 2004. Personnel shortages had closed ten facilities and approximately ten more were non-functional because of serious renovation and refurbishment needs. Although the Ministry of Health trained additional health assistants in 2004 and reopened most of its facilities in 2005, the RMI deferred dispensary construction work to FY 2006.

The Government of Japan funded the construction of a new Majuro hospital annex that will house administration, laboratories, and public health, dental and outpatient services. Once the annex is open in December 2005, reconstruction of the existing facility will commence. The renovation will focus on the wards, operating theaters, and hospital support areas. Equipment and furniture purchases and additional personnel will be required, and this will likely stall the Ministry's intent to redirect funding to prevention and primary care in the near future.

In September, a fire completely destroyed a section of the Majuro Hospital that housed the supply room. RMI officials estimated a loss of nearly $1 million in uninsured drugs and medical supplies. Outside donations of drugs and funding assistance helped mitigate the impact on patient care but restocking needs continue. Construction crews were diverted from other Compact infrastructure projects for the emergency repair and reconstruction of the facility.

The health sector continued to be a leader in implementing performance budgeting and monitoring in the RMI. The Ministry of Health developed a "performance matrix" to facilitate the collection and tracking of baseline data and annual progress. During 2005, efforts focused on determining the "measurability" quotient of the outcomes; establishing timing targets; and reevaluating and revising selected outcomes to isolate and track progress in such strategic areas as hospital improvements and the delivery of preventive services and primary health care on Ebeye. The identification of baseline data is incomplete but continued attention given to this area in FY 2006, along with the development of clearer linkages between outcomes and health status indicators, will undoubtedly help in the evaluation of funding use and effectiveness.

Public Infrastructure

The RMI allocated $13.45 million for infrastructure improvements and maintenance in FY 2005. This allocation is consistent with their policy that at least 30 percent of all annual United States Compact financial assistance be directed toward infrastructure development. To guide project selection, the RMI continues to utilize a comprehensive Infrastructure Development and Maintenance Program with complete project descriptions, timelines, financial requirements and measurable project indicators. Education is the priority sector targeted by Compact infrastructure assistance and has also received the largest portion (78 percent) of infrastructure development and maintenance funding over the past two years.

RMI Infrastructure Development and Maintenance Program projects that are listed below are for the Health and Education sectors with FY 2004 and FY 2005 funding. Projects include construction, maintenance, and purchasing of equipments:

IDMP 0001 Rita Elementary School Phase I
(Construction of two 4-classroom blocks)

Budget excl. A&E	*Contract Value*	*Expenditure to date*	*Estimated Final Cost*	*Percentage Complete*	*Completion date*
$1,043,478	$1,028,255	$976,842	$1,040,000	100	1 Aug 2005

Activities: Punch list completed.
Quality of Workmanship: Excellent.
Comments: Furniture delayed on PMO ship.

IDMP 0002 Laura High School Phase I
(Construction of one 4-classroom block)

Budget excl. A&E	*Contract Value*	*Expenditure to date*	*Estimated Final Cost*	*Percentage Complete*	*Completion date est.*
$660,978	$567,673	$388,130	$600,000	76	30 Nov 2005

Activities: Formwork and props to upper floor removed. Carpentry work on upper floor done. Electrical cable installed.
Quality of Workmanship: Good.
Comments: Progress is slow. Windows doors and flooring materials held up on PMO ship. Furniture contract awarded.

IDMP 0003 Laura Elementary School (Maintenance)
(8 classrooms and a library space)

Budget excl. A&E	***Contract Value***	***Expenditure to date***	***Final Cost***	***Percentage Complete***	***Completion date***
$208,000	$157,815	$204,193	$204,193	100	25 May 2005

Activities: Project completed.
Quality of Workmanship: Excellent.
Project Constraints: None.

IDMP 0004 Majuro Hospital Maintenance
(Painting, flooring, wall repairs, seating, isolation ward WC, door/ shelving repairs)

Budget excl. A&E	***Contract Value***	***Expenditure to date***	***Estimated Final Cost***	***Percentage Complete***	***Completion date***
$200,000	$179,925	$190,596	$200,000	100	10 May 2005

Activities: Project completed.
Quality of Workmanship: Good.
Project Constraints: None.

IDMP 0005 Ebeye Hospital Maintenance
(Programmed maintenance of mechanical, electrical and HVAC equipment, and architectural repairs)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date Ph 1
$307,502	$307,502	$233,114	$307,502	76	31 Dec 2005

Activities: Mechanical equipment maintenance and building repairs.
Quality of Workmanship: Good.
Project Constraints: None.
Comments: Variation being prepared for repair of oxygen, sterilization and other systems.

IDMP 0006 Jaluit High School Phase I
(Construction of two 8-classroom blocks and a dormitory)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$3,262,609	$2,752,000	NIL	$3,000,000	0	TBD

Activities: Mobilization in Majuro.
Project Constraints: The contractor has not started work.
Remedies: Rescheduling of the project.
Comments: Time extension claim received and under consideration.

IDMP 0007 Jaluit High School Kitchen Maintenance
(Kitchen finish repairs, new cooking equipment and flooring to the dining room)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$138,385	$77,885	NIL	$140,000	0	11/30/05

Activities: Architectural repairs to the kitchen completed.
Project Constraints: Flooring and other materials delayed by PMO shipping problems.
Remedies: Project rescheduled.

IDMP 0008 Health Center Maintenance I
(Health center maintenance on Southern atolls and Arno, 8 Centers in total)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$198,354	$198,354	$148,194	$198,354	83	October 2005

Activities: Work on Jaluit, Narmej and Arno completed.
Project Constraints: Local shipping schedule delayed commencement.
Remedies: Time extension and re-scheduling of project.
Comments: Scheduled work on all health centers has been completed. Additional doors, roofing repairs and electrical repairs are required. A variation has been prepared and additional materials are being sourced.

IDMP 0009 Education Maintenance I
(Elementary school maintenance on Majuro)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date
$130,796	$130,796	$110,050	$130,796	93	10 June 2005

Activities: Project completed with the exception of Ejit elementary school.
Quality of Workmanship: Good.
Project Constraints: None.
Comments: Final account under negotiation.

IDMP 0010 Marshall Islands High School Phase I
(Construction of an 8-classroom block)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$1,593,478	$1,180,316	$460,927	$1,250,000	43	31 Dec 2005

Activities last month: Blockwork walls to ground floor completed
Quality of Workmanship: Very good.
Project Constraints: None.
Comments: Workmen diverted to the emergency rebuild of the Majuro Hospital .

IDMP 0011 Northern Islands High School Phase I
(Construction of an administration building and a dormitory)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$1,221,739	$872,277	$430,231	$1,100,000	50	12/13/2005

Activities: Blockwork completed up to roof level, trusses being assembled.
Project Constraints: None.
Comments: The contractor is making excellent progress. Supervisor appointed.

IDMP 0012 MIHS Gymnasium Maintenance
(Floor and wall repairs, toilet construction in the school gymnasium)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$84,000	$65,594	$62,315	$66,594	100	1 Jul 2005

Activities: Project completed
Quality of Workmanship: Good.
Comments: Final account preparation.

IDMP 0013 MIHS Painting and Fencing Maintenance
(Painting of the two Japanese-funded buildings and fencing of the staff quarters)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date
$50,000	$99,679	$94,696	$100,000	100	9/11/05

Activities: Fencing work has commenced.
Quality of Workmanship: Good.
Project Constraints: Fencing materials held up on PMO ship in Hawaii.
Remedies: Project partially rescheduled.

Comments: Variation to contract required by supply of administration block roof sealing materials, and inspection and temporary repair of the classroom ceilings currently being assessed.

IDMP 0014 Health Center Maintenance II
(Health center maintenance on the Eastern atolls)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$200,028	$203,587	$33,752	$205,000	20	1 Nov 2005

Activities: Materials arrived and were loaded onto delivery vessel.
Project Constraints: Materials arrival delayed by PMO shipping problems.
Remedies: Rescheduling of the project.
Comments: Construction scheduled to commence in mid October.

IDMP 0015 Education Maintenance III
(Elementary school maintenance on Jaluit and Arno atolls)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$201,173	$220,185	$30,204	$221,000	15	1 Nov 2005

Activities: Materials arrived and were loaded onto delivery vessel.
Project Constraints: Materials arrival delayed by PMO shipping problems.
Remedies: Rescheduling of the project.
Comments: Construction scheduled to commence in mid October.

IDMP 0016 Ailuk Elementary School (Education Maintenance Project)

Budget excl. A&E	Contract Value	Expenditure to date	Estimated Final Cost	Percentage Complete	Completion date est.
$60,616	$59,000	$8,729	$60,000	15	1 Nov 2005

Activities: Materials arrived and were loaded onto delivery vessel.
Project Constraints: Materials arrival delayed by PMO shipping problems.
Remedies: Rescheduling of the project.
Comments: Construction scheduled to commence in mid October.

Public Sector Capacity Building

The RMI Public Sector Capacity Building grant for FY 2005 was for the amount of $103,514. This was used to partially fund the payroll of the Auditor General's Office.

Private Sector Development

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

- Trade and Investment Promotion: Trade promotion focused on promoting opportunities for Ebeye businesses at the US Army installation on Kwajalein and to increase overall participation of the Ebeye community. The Investment division has worked to educate political leaders about issues related to trade promotion.

- Land Registration: The RMI continued to register land and to convert relevant paper documents into an electronic date base. The shift from traditional land processes to formal land registration in the Pacific is a culture change. However, the RMI is working to educate the public about the benefits of registering land holdings with the government. Two properties were registered this fiscal year, 180 documents were entered into the database, and 79 applications for registration were given out.

- Tourism Promotion: The RMI has worked to reach potential clients through its Japan office which is partly funded with Compact funds. This year the main focus of this office is the 6-month trade expo hosted by Japan. Staff work to disseminate information about local products, tourism opportunities, and fisheries. Funds were also spent on traditional print advertisement and staff training.

- Small Business Development: The Small Business Development Center (SBDC) continued to conduct trainings and counsel clients on business development plans. The SBDC has helped to start eight new small businesses. The SBDC also completed a survey of current business opportunities in the RMI. Finally, the SBDC serves as a third party to help local funding agencies and small businesses work towards agreement.

Environment

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

- Environmental Health and Water Quality: The RMI continued to collect and test water samples. In 2004, only 23 percent of the samples collected were deemed safe for drinking. In 2005, 273 samples have been collected but test results have not been provided.

- Land and Coastal Management: A coastal water specialist was hired by the department this fiscal year. The coastal management plan for Majuro was completed. The RMI is working to finish Coastal Management Plans for the outer islands.

- Biodiversity: Officials began surveying coral reefs in an effort to develop baseline date on the health of the reefs. Once the baseline has been established, performance measures and goals will be developed from there.

- Solid and Hazardous Waste: A Solid Waste Committee was established by the RMI cabinet to address the current management crisis on Majuro. Multiple agencies with varying roles are responsible for managing solid waste on Majuro. It is hoped that the committee will help streamline and clarify roles between the agencies and adopt and implement a sustainable solid waste management plan. A draft policy for solid waste was published.

- Education and Awareness: Public education and awareness sessions were conducted in school and community groups, about 10,000 people attended the sessions during the first six months of the fiscal year. EPA also conducted a weekly radio program and disseminates information to the local newspaper to further educate the public about environmental concerns or events.

- Information Management: EPA completed work to develop a website for the agency. The office also implemented an intranet to allow information sharing between employees.

- Planning, Human Resources, Administration: EPA revised its strategic plan and continues to implement changes. Starting this fiscal year, staff, in coordination with the Deputy General Manager, started to complete monthly work plans.

Ebeye Special Needs

The RMI received $3.1 million in funding for Ebeye Special Needs for education and health uses in FY 2005. The education sector applied its allocation of $1.6 million to provide basic primary and secondary services to Kwajalein Atoll students. The $1.5 million awarded to the health sector supported the recurring costs of Ebeye Hospital and Kwajalein preventive and primary care services, as well as cover operational improvements.