Republic of the Marshall Islands

November, 2019

ECONOMIC REVIEW

RMI FY 2018

FULL REPORT

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ECONOMIC REVIEW

RMI Fiscal Year 2018

Abbreviations

ADB	—	Asian Development Bank
amended Compact	—	second phase of the Compact, FY2004–FY2023
AMI	—	Air Marshall Islands
BoP	—	balance of payments
CAP	—	Comprehensive Adjustment Program
c.i.f.	—	cost, insurance and freight
CMI	—	College of the Marshall Islands
Compact	—	RMI Compact of Free Association with the US
Compact I	—	first 17 years of the Compact, FY1987–FY2003
CPI	—	consumer price index
CRP	—	Comprehensive Recovery Plan
CTF	—	Compact Trust Fund
DMP	—	Decrement Management Plan
DSA	—	debt-sustainability analysis
EPPSO	—	Economic Policy, Planning and Statistics Office
FAA	—	Federal Aviation Administration
FDI	—	foreign direct investment
FMM	—	Fiscal Management Model
FSM	—	Federated States of Micronesia
GDE	—	gross domestic expenditure
GDP	—	gross domestic product
GFS	—	Government Finance Statistics
GNDI	—	gross national disposable income
GNI	—	gross national income
GRT	—	gross receipts tax
GVIC	—	Great Village International Consultants
ICT	—	information and communication technology
IIP	—	international investment position
IMF	—	International Monetary Fund
JEMFAC	—	Joint Economic Management and Financial Accountability Committee
JICA	—	Japanese International Cooperation Agency
KAJUR	—	Kwajalein Atoll Joint Utility Resources
MEC	—	Marshalls Energy Company
LTEFF	—	Long Term Economic and Fiscal Framework
LTFS	—	Long-Term Fiscal Strategy
MIDB	—	Marshall Islands Development Bank
MIMRA	—	Marshall Islands Marine Resources Authority
MISC	—	Marshall Islands Shipping Corporation
MISSA	—	Marshall Islands Social Security Administration
MTBIF	—	Medium-Term Budget and Investment Framework
MTEF	—	medium-term expenditure framework
MTFF	—	medium-term financial framework
MWSC	—	Majuro Water and Sewer Company
NEER	—	nominal effective exchange rate
NPT	—	net profits tax
NTA	—	National Telecommunications Authority
PEFA	—	Public Expenditure and Financial Accountability
PFM	—	public financial management
PFTAC	—	Pacific Financial Technical Assistance Center
PNA	—	Parties to the Nauru Agreement
PNG	—	Papua New Guinea
PSP	—	Public Sector Program
PSRP	—	Public Sector Reform Program
REER	—	real effective exchange rate
RIF	—	reduction in force
RMI	—	Republic of the Marshall Islands
ROC	—	Republic of China
RUS	—	Rural Utilities Service
SEG	—	Supplemental Education Grant
SOE	—	state-owned enterprise
SPV	—	Special Purpose Vehicle
SS	—	Social Security
TA	—	technical assistance
TRAM	—	Tax and Revenue Reform and Modernization Commission
US	—	United States
VAT	—	value-added tax
VDS	—	Vessel Day Scheme

NOTE The Republic of the Marshall Islands government's fiscal year (FY) ends on September 30.

CURRENCY EQUIVALENTS
Currency unit: United States dollar (US$)

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Disclaimer

The views, thoughts and opinions expressed in this review are those of the authors and represent an independent assessment of the economic performance of the Republic of the Marshall Islands (RMI). This document does not necessarily represent the views of the government of the RMI, the Graduate School USA, nor any other organization, committee, group, or individual, real or implied.

Foreword

This review has been prepared to assist both the RMI and US governments in fulfilling their respective obligations under the Compact of Free Association with the United States. In the case of the RMI, the amended Compact states, under Title One, Section 215, that

> *the Government of the Republic of the Marshall Islands shall report annually to the President of the United States on the use of United States sector grant assistance and other assistance and progress in meeting mutually agreed program and economic goals. The Joint Economic Management and Financial Accountability Committee shall review and comment on the report and make appropriate recommendations based thereon.*

Similarly, the president is required to submit to Congress a report on economic developments in the RMI:

1. *REPORT BY THE PRESIDENT. Not later than the end of the first full calendar year following enactment of this resolution, and not later than December 31 of each year thereafter, the President shall report to Congress regarding the Federated States of Micronesia and the Republic of the Marshall Islands, including but not limited to—*

    A. *general social, political, and economic conditions, including estimates of economic growth, per capita income, and migration rates;*

    B. *the use and effectiveness of United States financial, program, and technical assistance;*

    C. *the status of economic policy reforms, including but not limited to progress* *toward establishing self-sufficient tax rates;*

D. the status of the efforts to increase investment, including: the rate of infrastructure investment of U.S. financial assistance under the U.S.-FSM Compact and the U.S.-RMI Compact; non-U.S. contributions to the trust funds; and the level of private investment; and

E. recommendations on ways to increase the effectiveness of United States assistance and to meet overall economic performance objectives, including, if appropriate, recommendations to Congress to adjust the inflation rate or to adjust the contributions to the trust funds based on non-U.S. contributions.

While this review relates to FY2018, analysis of developments in that year alone would provide a limited and one-sided view. The approach has been rather to review developments in a broader context over the amended Compact period so that a more informed assessment can be made.

This review has been prepared with funding assistance from the US Department of the Interior's Office of Insular Affairs (http://www.doi.gov/oia) and is administered through the Graduate School USA (http://www.graduateschool.edu). It is not intended to directly fulfill the reporting requirements of the two governments but rather to assess the RMI's economic performance and policy environment and to present a set of economic statistics. Much of the material will be directly relevant to the two nations. However, the reporting requirements of the two governments are different; thus, not all the material will be relevant to both reports.

The review and statistical appendix have been prepared by a team: Mark Sturton, who developed the economic review, and Glenn McKinlay, who jointly compiled the statistics with Sturton. Thanks go to the acting chief secretary, Kino Kabua and her predecessor, Ben Graham; Secretary of Finance Maybelline Andon; and Fred DeBrum, Junior Peter, John Henry and the staff at the Economic Policy, Planning and Statistics Office (EPPSO). We are also grateful to Public Auditor Junior Patrick and many RMI businesspeople who support the annual preparation of this review and the statistical appendix.

Finally, a digital copy of this review and the accompanying statistical appendices and Macroeconomic and Fiscal Forecasting Framework in various digital formats is available online at http://www.econmap.org.

Summary

A. Economic Performance

ECONOMIC PERFORMANCE

The RMI economy performed well in FY2018 with 3.5 percent growth in gross domestic product (GDP), nearly sustaining the 4.1 percent attained in FY2017 after the three previous years of weak performance. During FY2018 the largest contributor to economic growth was the manufacturing sector, which added 1.2 percent to GDP. This reflects increases in copra-processing value added following the large increase in subsidies and producer prices paid to growers. The sector also includes the Pan Pacific fish-loining plant, where value added also rose significantly. Other major contributors have included the fisheries sector and an increase in construction activity following a resumption in disbursements of the Compact infrastructure grant after the moratorium placed on the use of the grant in FY2014 and FY2015. Performance at Air Marshall Islands (AMI), the national airline, has also improved, with value added rising significantly (from very low levels), although the entity operates below cost and remains financially insolvent.

EMPLOYMENT

During the amended Compact period, employment opportunities have grown by an average 0.7 percent annually. Employment generation in the private sector has fluctuated with the phase of the cycle and has been strongly affected by the closing and re-opening of the fish-loining plant. However, at the current time, private sector employment is at a similar level to that at the start of the amended Compact. The public sector at large has, however, expended, growing by 1.7 percent during the period. Much of this growth reflects increased employment opportunities in the state-owned enterprise (SOE) sector, government agencies and local government. Hiring by the national government has been more constrained, having grown at a rate comparable to the economy as a whole. Employment at the military base in Kwajalein has dropped by an average of 1.9 percent, reflecting implementation of new technology allowing for some job relocations, primarily to Huntsville, Alabama. Since FY2014, however, employment has stabilized. While the growth in employment has been positive during the amended Compact period, it has been unable to provide a sufficient level of job opportunities for a growing labor force.

INFLATION

After a period of negative inflation in FY2015–FY2016 with falling world oil prices, inflation stabilized in FY2017, recording a 0.0 percent change and growing modestly by 0.8 percent in FY2018. This follows negative inflation of 1.5 and 2.2 percent in the previous two years. The major forces in FY2018 were an increase in food prices of 1.3 percent and a rise in transportation costs of 2.8 percent, reflecting rises in world oil prices. Overall, the reduction in the price level since FY2014 has helped moderate the cost of living.

WAGES

Wages have grown modestly in the RMI by 2.5 and 1.5 percent per annum in the private and public sectors, respectively, during the amended Compact period since FY2003. However, once inflation has been taken into account, real wages have fallen in the two sectors by 0.1 and 1.0 percent, indicating slowly declining standards of living. Only at the Kwajalein military base have wages managed to maintain their real levels. The wage differential between the private and public sectors, however, remains large.

B. The Financial Sector

BANKING

Commercial bank lending in the RMI is more active than in the Micronesian sister states of the Federated States of Micronesia (FSM) and Palau and achieved a loans-to-deposit ratio of 56 percent (FSM 22 percent, Palau 13 percent). The greater lending performance reflects the more active lending policy of the local bank: the Bank of the Marshall Islands (BOMI), which is not FDIC insured and comes only under local supervision. However, the inability of businesses to prepare meaningful business plans and financial statements, lack of collateral and the limited ability to use land as security have inhibited further financial intermediation. One bright spot that has enabled lending against moveable chattels has been the introduction of secured-transactions legislation and registry. With limited opportunities, commercial banks have preferred to invest their assets offshore in less risky and more secure markets.

A troublesome issue for the RMI has been the worldwide phenomenon of "de-risking" by international financial institutions. In order to reduce exposure to money laundering and financing of terrorism and to avoid stiff penalties imposed by regulatory authorities, international banks are reducing their exposure through limiting correspondent-banking relationships (CBR). BOMI has been under threat of losing its correspondent bank, First Hawaiian Bank. First Hawaiian has been satisfied with recent progress at BOMI to tighten anti-money-laundering (AML) and improve procedures for combating the financing of terrorism (CFT), but a permanent CBR solution needs to be found. Until such time, BOMI and the RMI financial sector remain at significant risk.

A further issue relating to banking is the high level of consumer debt relative to household incomes. Consumer debt represents 35 percent of GDP and 61 percent of compensation of employees. Consumer debt attracts a high rate of interest—13 percent in FY2018—and is largely secured against payroll of public sector employees through direct allotment, thus guaranteeing repayment. As a result, employees in government are at high risk of debt stress. After payment of taxes, Social Security (SS) contributions and so on, and as much as 50 percent deducted for loan repayments, many national-government employees are left with a very low level of net take-home pay, thereby threatening their ability to sustain spending on basic family needs.

EXTERNAL DEBT

RMI external debt remains significant and was characterized by the International Monetary Fund (IMF) in a recent debt-sustainability analysis (DSA) as reaching a level that placed the RMI at a "high risk of debt distress." Nevertheless, external debt continued to decline as a percentage of GDP, falling from 72 percent of GDP at the start of the amended Compact period to 33 percent in FY2018. Total repayments of principal and interest represent 10 percent of general-fund revenues, a measure of unconstrained government revenues. Debt service was a major issue for the government in the past with periods of delinquency. However, the RMI has resolved these issues and has been up to date during recent years.

As a result of being designated at "high risk of debt distress," the RMI has now been accorded "grant only" status by the World Bank and the Asian Development Bank (ADB) and is, for the time being, ineligible for concessionary loan finance. This has both benefits and costs. With respect to debt levels, the benefit is unambiguous: the RMI is now experiencing a period of enforced declining debt to GDP as existing loans are repaid and new loans are not being undertaken. Recent government interest in embarking on social-sector loan-funded projects, which would not be compliant with the World Bank's grant-only status, threatens to undermine access to donor grants. It is also understood that viable projects, such as energy-sector loans, can be issued an exception to the grant-only restrictions on the basis that the terms of the loan are deemed concessional using the World Bank calculation tool.

SOCIAL SECURITY SUSTAINABILITY

A major pressing fiscal issue facing the RMI has been the potential collapse of the SS system. In an effort to avoid collapse, the Nitijela enacted legislation in 2017 to raise employer and employee contributions from 7 to 8 percent, increase the maximum quarterly taxable wage from $5,000 to $10,000, reduce benefits by 0–10 percent and extend the retirement age to 65 over a number of years. The impact of the reforms has been to defer the eventual collapse of the fund beyond 2030. While the mismatch between contributions and benefits has narrowed significantly, it is projected to worsen over time. With little growth in the workforce and increasing numbers reaching retirement age, the system remains fragile. Recognizing these weaknesses, the government transferred $3.3 million in FY2017 and $3.0 million in FY2018 to shore up the system's reserve fund—a level of payment that must be sustained well into the future to avoid fund collapse without further basic reforms to the system. Maintaining this level of support will require strong commitment given other priorities the RMI may face after FY2023.

CRYPTOCURRENCY AND THE SOV

In March 2018 the RMI declared its intent to issue a digital currency based on blockchain technology to be known as the SOV. The SOV is to act as legal currency in the RMI in addition to the use of the US dollar. An "appointed organizer," appointed by the cabinet, is to take responsibility for the initial currency offering (ICO) and for development of the blockchain technology and software to transact in the currency of the RMI. An initial 24 million SOVs are to be issued, half of which will be held by the RMI government and the remainder owned by the organizer. The minister of finance is to be responsible for regulation of the SOV, and the banking commissioner will be responsible for compliance with standard Know Your Customer (KYC) procedures.

The passage of the law to issue the SOV as legal tender resulted in widespread interest and concern from international institutions. While many cryptocurrencies exist, none have been issued as legal tender by a sovereign state. Many central banks have examined the potential to issue a digital currency to the public, backed by the currency in circulation, but so far, they have been cautious about issuing their own digital currencies. The RMI proposal thus represents an effort not specifically attempted before.

While the potential gains from sale of the SOV could be large, many risks have been identified. Anonymity of transactions has been one of the major concerns, especially the facilitation that cryptos afford to money laundering and financing of terrorism. The RMI proposes to remedy this concern through the KYC provisions in the law. However, it is not clear how these would be maintained in jurisdictions outside the RMI or after the ICO. Since anonymity is one of the major attractions of cryptos, the absence of this provision would limit uptake of the SOV.

Another concern has been the risk to the CBR relationship of BOMI with First Hawaiian Bank. Perceived AML and CFT risks associated with cryptocurrencies may adversely affect BOMI's CBRs with First Hawaiian or other international banks or the establishment of BOMI's own facilities in the US. It is also not clear what the position of the Federal Deposit Insurance Corporation (FDIC) might be regarding the other bank in the RMI, the Bank of Guam, accepting and holding SOVs on its balance sheet. A further issue is volatility in the value of cryptos, which have displayed high levels of price/value volatility. Should the SOV be taken up actively within the RMI, such volatility could prove highly destabilizing and could disrupt orderly payments. While this might not have been the designers' intention, the currency is intended to be issued as legal tender.

The current position of the government that has emerged since the enactment of the legislation is that the RMI will not proceed with SOV issuance until it has received full approval from US authorities. Selection of an "appointed organizer" will be delayed for a two- to three-year period while independent expert advice is sought and the many risks that have been identified have been resolved.

C. Fiscal Performance and Policy

THE FISCAL OUTTURN

The RMI achieved a large fiscal surplus in FY2018 of 2.5 percent of GDP, a reduction from the large 4.4 percent surplus achieved in FY2017. This was the fourth year in a row of strong performance. Revenues contracted from their FY2017 level by 5 percent, reflecting a return of fishing-fee income to normal levels after the large drawdown of Marshall Islands Marine Resources Authority (MIMRA) reserves in the prior year. In FY2016 fishing-fee income rose to $26 million, reflecting past growth in the vessel-day price. With the additional drawdown of $13 million, fishing revenues peaked at $40 million in FY2017. In FY2018 fishing-fee income, at $29 million, fell back to a normal level, but it still indicates continuing underlying growth. Tax income continued to be buoyant, reflecting the growth in the economy, while fees from the shipping and corporate registry remained steady.

On the expenditure side, overall expense remained stationary and the prior upward momentum came to a halt, reflecting the reduced level of revenues. However, payroll expense continued to grow (by 5 percent) as did use of goods and services (by 14 percent). The main offsetting items were significant reductions in subsidies, grants and other expense, which all contracted from the high levels of the prior year's budget as was required to maintain overall fiscal balance. While subsidies to Tobolar rose to $4.5 million, AMI, KAJUR and the National Telecom Authority (NTA) all faced reductions. While the government maintained the commitment to SS with a $3 million transfer, it failed to transfer the $3 million committed to in the FY2018 budget to the Compact Trust Fund (CTF). Overall, the FY2018 outturn was a stabilization budget after the rapid expansion in expenditures of the prior two years.

The very significant improvement in the revenue position has unfortunately been accompanied by large matching increases in expenditures during the FY2015–FY2017 period. The FY2018 budget stabilized the prior rapid expenditure growth, but in real terms it remained 40 percent above the FY2014 level, before the boom in fishing-fee revenues. While the attainment of significant surpluses is to be congratulated, the lack of discipline in controlling expenditures is of serious concern. Fiscal policy lacks a fiscal-responsibility framework to encourage the prudential management of abundant current resources to meet future needs arising from declining Compact grants, an insufficient CTF corpus to reliably replace the grants and an underfunded SS system.

TAX REFORM

With a tax/GDP ratio of 15 percent, RMI revenue effort is low and presents an opportunity to adjust to future fiscal shocks and to create an efficient tax environment that supports private sector development. In 2008 the RMI initiated a process to consider tax reform. With support from the IMF and Pacific Financial Technical Assistance Center (PFTAC), a reform agenda was thrashed out to include a value-added tax (VAT) as the centerpiece, a net profits tax, repeal of the existing gross receipts tax (GRT) and the creation of a revenue-administration authority. Laws were drafted and submitted to the Nitijela for consideration in November 2011. However, elections have come and gone, and no action has been taken since that date. While there was some renewed interest in the tax-reform proposal at the start of the current administration, the proposal failed to garner momentum; it will be up to the new government to be formed in January 2020 to consider this important reform.

The failure to reform the tax system has put on hold efforts to improve tax administration: improving management practices, adopting modern procedures, improving staff training and implementing new information and communication technology (ICT) systems. The existing revenue and customs divisions in the Ministry of Finance have endured a long period of neglect, and efforts to strengthen capacity should be put in place, regardless of the status of the tax-reform initiative. A second phase of the existing World Bank and ADB public financial management (PFM) support would be ideal. New ICT systems are needed both to support tax-collection efficiency and to improve flows of key economic information, such as trade data and indicators on domestic businesses' production.

D. Public Financial Management

PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY

In December 2011 the RMI underwent an external Public Expenditure and Financial Accountability (PEFA) assessment, and the cabinet adopted the report and directed the government to request the PFTAC to compile a PFM "road map." In collaboration with the government, the PFTAC prepared a road map for 2014–16, but no action to implement the road map was taken. As part of the ADB 2018-20 project cycle, there is a $2 million PFM project to support the Ministry of Finance, with the PEFA road map providing the focus of the reforms. The major initiative has been strengthening the Ministry of Finance with an improved staffing level and focusing upon financial management, accounting and controls. An additional focus has been the establishment of an SOE-monitoring unit (SOEMU), which is part of the ADB PFM project. Both initiatives are well under way, but whether durable improvements are achieved has yet to be seen. The EU has also agreed to provide budgetary support for the reform of the energy sector (EDF 11, $9.6 million), and the government has committed to PFM reforms as part of the conditions. The ADB PFM project, the EU energy project, and more recently World Bank interest in the area will support and encourage improved PFM.

FINANCIAL-MANAGEMENT INFORMATION SYSTEM

The financial-management information system (FMIS) in the RMI is nearing the end of its effective life as the responsible software company and is no longer operational. With donor grant support of $9 million from the World Bank for budget execution and financial reporting systems, a replacement system is being actively pursued. The project has now been approved by the World Bank's board, and implementation has now commenced and will take place over a period of years. Enhanced reporting and a new chart of accounts should enable improved information for budgeting and for fiscal and performance management.

PUBLIC SECTOR PAYROLL

With public payroll representing a high proportion of GDP, 22 percent in FY2018, careful monitoring of trends is warranted with anticipation of declining resources after FY2023. Before the start of the amended Compact period, there were 1,909 public servants, a figure that today stands at 2,619. However, a significant increase of 28 percent occurred in the first two years in response to the depressed levels of public employment following the reforms of the late 1990s. This increase was also affected by the incorporation into government of the Head Start federal program. That program was previously run as an autonomous agency during the original Compact period. Since FY2006 only another 182 positions have been added, representing 0.6 percent annual growth. Payroll costs, on the other hand, have risen gradually over the period, reflecting a 2 percent annual wage increase. Payroll costs as a percentage of GDP have fallen since FY2004 from 24 to 22 percent. While the government has maintained discipline since FY2006, the increase at the start of the amended Compact may have been excessive in relation to the potential for efficiency gains in the delivery of public services.

SOE REFORM

With high levels of subsidies and capital transfers to the SOE sector, at an average of 11 percent of GDP over the last three years, the ailing sector remains a major source of concern and fiscal risk. The recent growth in subsidies for copra producers from 30¢ to 50¢ a pound to enhance outer-island incomes has had a large fiscal impact. From a level of $1.4 million in FY2014, payments to Tobolar, the copra-processing unit through which the subsidies are channeled, have grown to $4.5 million in FY2018. During FY2019 the budgeted amount rose to $6 million, but by mid-fiscal year the funds had been exhausted and a further loan from the Marshall Islands Development Bank (MIDB) had been arranged, bringing the total to $12 million. While income support to the outer islands is important, the level of subsidy has grown at an unsustainable rate.

Recent legislation, the 2015 State Owned Enterprise Act, requires SOEs to operate on a commercial basis and to identify community-service obligations (CSOs), and it requires the establishment of an SOEMU in the Ministry of Finance. However, the law was amended to allow an increase in board representation by public officials, from one to three, including government ministers. This works against the reform objective to eliminate political involvement in SOE management. The law requires SOE management to fall under the minister of finance because of the fiscal implications and to support the commercialization objective. While the law provides a sound basis for SOE management, the main challenge will be the lack of capacity and skilled management to implement the law both at the SOE level and in the proposed new SOEMU. Part of the ADB PFM project provides resources for the establishment of the monitoring unit, which commenced work in 2018.

BOOMING DONOR SUPPORT AND CAPACITY LIMITATIONS

After a period of relative calm in donor support, the RMI has embarked on a period of significant activity. As a result of the World Bank's determination that the RMI is at high risk of debt distress, the ADB has placed the nation on a grant-only basis with a commitment to an annual transfer of $6 million with a further increase to $13 million. Under its current funding cycle (IDA) 18 and with grant-only status, the World Bank is understood to have resources to the tune of $20 million annually, with a further increase in funding on the horizon. Accordingly, the RMI has a total of over $130 million of potential projects in the pipeline. The EU has an EDF 11 grant of €9 million for energy-related investments and budgetary support, coupled with a GIZ project of €9.5 million for low-carbon-emission sea transport. JICA has projects of $10 million, with further contributions from Taiwan of $4 million and $1 million from NZ aid. All in all, there is approximately $250 million in possible projects, a quantum leap in planned donor-supported activity, but there is severely limited capacity to implement the projects on the ground. For an office that is hard pressed to prepare its annual audits on time, the Ministry of Finance hardly has time to entertain all the visiting missions, let alone prioritize and organize implementation.

E. Private Sector Developments

FISHERIES AND THE DOMESTIC FLEET

The fisheries industry in the RMI comprises provision of shore facilities to skipjack-tuna purse-seine operators, a home base for longline sashimi-grade operations, a fish-loining plant, and a variety of small domestic fishing activities. The contribution to the economy has grown significantly during the amended Compact period from $7.5 million in constant prices at the start to $15.5 million in FY2018. Total fish-licensing and associated fees collected by the MIMRA have also grown from $3.5 million in FY2010 to $32.2 million in FY2018. Much of the increase has been in the last five years because of the implementation of the Vessel Day Scheme (VDS) of the Parties to the Nauru Agreement (PNA). The PNA is, in effect, a cartel of nine Pacific Island states that, because of the introduction of the VDS, has led to a remarkable increase in member-country revenues. Daily fishing rates to third-party foreign fishing vessels currently average over $11,000 and $12,000 per vessel-day, and the RMI received over $28.8 million of revenues from this one source in FY2018.

An emerging concern for the PNA region is the operation of the FSM Arrangement (FSMa). The FSMa was established to encourage the development of domestic fishing fleets and to permit access to fishing resources of other parties' fleets. Fishing operators are accorded domestic fishing-fleet status under the FSMa and pay a reduced daily rate in the vicinity of $7,000 per day. The issue concerns whether the reduced fishing fee and loss in revenue are offset by increases in benefits to the PNA economies. In the RMI case, the Koos fishing company operates four purse seiners and a further boat under a joint equity venture with the government. Pan Pacific operates five boats and the loining plant, the plant's operation shows a significant recorded loss. It can be presumed that those losses are offset by the benefit of securing the reduced domestic-fee rate.

Preliminary indications from an ongoing study of the fisheries sector by the Graduate School USA suggests the additional benefits to the RMI economy from domestic vessels compared with bilateral vessels is close to $500 per day. If the benefit estimates prove correct, this means discounts to domestic vessels that exceed $500 per day result in net losses to the economy. However, estimating the costs and benefits is complicated by the need for domestically flagged vessels to pay transfer fees to other participant FSMa members when fish are caught in their waters. The analysis also needs to include estimates for inbound transfers from other countries' FSMa vessels fishing in RMI waters. The preliminary results from the Graduate School study suggest it is most probable the RMI incurred losses through participation in the FSMa. Arrangements such as that developed in PNG in which discounts are provided in proportion to demonstrated and proven benefits may provide a more economically efficient method to encourage development of the domestic fishing industry. For 2019 the RMI has increased the fees to domestic vessels, meaning the gap may now be reduced and the discounts at a level easier to justify by benefits from domestic vessels.

THE WORLD BANK'S DOING BUSINESS SURVEY

The World Bank's Doing Business Survey paints a discouraging picture of the environment for private sector development. Out of 190 countries, the RMI currently ranks 150th, 79 percent down the list, indicating that there is much room for improvement. The RMI fares worse than Palau but better than the FSM, which are ranked 133rd and 160th, respectively, but is substantially below most of the South Pacific nations. Samoa is ranked 90th, Tonga 91st, Vanuatu 94th, Fiji 101st, and Papua New Guinea 108th. Overall, the RMI's scores are generally weak. Registering property and protecting investors score in the bottom decile of countries, while scores for getting electricity and resolving insolvency are also very weak.

PRIVATE SECTOR REGISTRATION AND LICENSING

A recent assessment of the private sector (Private Sector Assessment, ADB) for the RMI provides a useful analysis of the regulatory environment of the private sector. The list of areas for reform is long. In the RMI, corporate business registration is conducted through the attorney general's office. The existing system relies on manual processes that are slow and time consuming. A modern computerized business-registration process in the public domain is required so that businesses can be legally identified for commercial transactions.

The RMI lacks a business-licensing law, although local governments have the power to issue licenses and collect fees under the Local Government Act. This has led to a lack of transparency and to discretionary decision making at the local level. Reforms could combine registration and licensing into a single process, but local governments would need compensation for lost revenue.

FOREIGN DIRECT INVESTMENT

Foreign direct investment (FDI) is implemented under the Foreign Investment Licensing Act of 2005, but the act appears to have failed to simplify the process as it was intended to do. FDI permitting is manually operated, and licenses take weeks or months to process. FDI licenses are only issued after all other regulatory requirements, such as corporate registration, local government licensing, foreign work permits, and SS registration have been fulfilled. To reduce uncertainty, an automatic process is required in order to allow other legal requirements to be fulfilled on a parallel timeline, as required for any other domestic enterprise. There is a substantial list of restricted activities, which appears not to be enforced. This can encourage "front" businesses that distort economic activity and undermine the rule of law. In a modern FDI regime, businesses are only required to submit information required for statistical and monitoring purposes, and licenses should be issued in a matter of days.

LAND TENURE

In the RMI, as in many Pacific Island economies, land is largely owned by customary groups with complex governance structures. Banks are reluctant to take customary land either owned or leased for collateral. Non-Marshallese are not allowed to own land, and even transactions between Marshallese are rare. A key objective of economic development is to improve tenure security for both landowners and leaseholders by accurately defining and protecting land rights. In 2004, with ADB support, the Land Recording and Registration Act was introduced as a voluntary means for customary owners to register land and develop an accessible registry of land transactions. The Land Registration Authority (LRA) was introduced to implement the new legislation. However, the uptake in use of the LRA has been minimal, and currently only seven land parcels have been registered and 35 title applications filed. Despite the slow uptake, the 2004 legislation and LRA are generally considered to provide a sound basis for land administration. The process of improving public awareness, with both government and private sector backing, needs reinitiating so that secure registration and leasing of land can support its critical role in business and financial development.

F. Compact Issues

THE RMI COMPACT TRUST FUND

The RMI CTF experienced market gains during FY2018 of 7.0 percent. Together with a scheduled contribution from the United States of $16.85 million at the outset of the year and of $2.4 million from Taiwan midyear, those gains enabled the fund to grow by $45.5 million to an end-of-FY2018 balance of $402.4 million. During the period of investment since the outset of FY2006, the annualized rate of return has been 6.68 percent.

Assuming the pledged contributions from Taiwan continue, the CTF would only need to grow at 1.34 percent annually from FY2019 to FY2023 to achieve a level sufficient to provide a smooth transition to CTF distributions from FY2024 onward at the projected real value of FY2023 sector grants ($26.65 million). While there is a good chance of achieving such returns, this "simple" sustainability estimate relies upon performance during the distribution period at a 5.0 percent real rate of return and does not allow for market volatility. The Graduate School has modeled outcomes under the CTF distribution rules in the presence of market volatility. The model results for the RMI indicate a significant probability of periodic fiscal shocks, including years in which zero dollars are legally available for distribution. Notably, over the period FY2024–FY2063, 56 percent of cases simulated show one or more years of zero distribution.

No distribution rules would simultaneously allow for (i) protecting the real value of the CTF corpus, (ii) ensuring distributions at or near the real value of the FY2023 grants, and (iii) avoiding year-to-year volatility of distributions. However, recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost. A key empirical finding is that once market volatility is accounted for, the CTF would need to be approximately 1.67 times larger than estimated using a simple fixed rate of return with no market volatility. For the RMI, achieving this "SAFER" sustainability estimate of $909 million for its CTF would require growth at 13.25 percent annually from FY2019 to FY2023. The median expected outcome for the value of the CTF at the end of FY2023 is $664 million, which is $245 million less than the SAFER figure described above.

Making substantial improvements to the terms of the CTF Agreement would require mutual agreement by the original parties, which for the United States entails both executive and congressional approval.

POST-FY2023 UNCERTAINTIES

Annual sector grants, infrastructure and disaster assistance are set to expire in FY2024 except for those dedicated to Kwajalein. The loss of approximately $27.2 million in FY2024, inflation adjusted thereafter, is targeted to be replaced by funding provided from distributions from the CTF; however, there is considerable uncertainty over the continuation of many other special and federal programs and services the RMI receives from the United States. In particular, the RMI benefited from the Special Education Grant (SEG) of $4.8 million in FY2018, which was cashed out from former federal programs provided during the original Compact funding period. SEG funding is provided through discretionary, annual congressional appropriations that will end after FY2023 under current law. There are many further US federal programs, such as postal services, FDIC, NOAA, Pell grants, Federal Aviation Administration (FAA), and health programs, that are subject to congressional authorization.

While the shortfall in fully sustainable distributions from the CTF is estimated to be $7.0 million after FY2023—representing a 26 percent decline from the $27.21 million target in FY2024 for sector grants—the range of possible values in the loss of federal programs may, in a truly severe case, be a further $20 million or more. In the remaining years of the amended Compact through FY2023, clarity is required on the status of these programs so that the RMI can effectively plan for the onset of the CTF distribution period.

G. Other Issues

CORPORATE AND SHIPPING REGISTRY

An issue that has attracted considerable interest is the corporate- and shipping-registry services provided to the RMI by the Trust Company of the Marshall Islands (TCMI), which is a wholly owned subsidiary of a US company, International Registries. The registry provides services for nonresident corporate-registration and shipping services. Under the terms of the Compact, vessels registered in the Marshall Islands are treated as if they are US-registered vessels; as a result, many large US shipping companies use the Marshall Islands for registering their ships. At the start of the amended Compact, the RMI government received $1 million annually from the registry, which rose to $7 million in 2018 and is planned to rise to $8 million in 2020 when the agreement between the RMI and the TCMI expires. There is a general lack of factual information and transparency on the operations of the TCMI. There is no publicly available financial information on whether the RMI receives a fair share of the earnings, although it is known that in similar jurisdictions the host nations receive a far higher return. There is thus a need for a transparent evaluation, particularly when there is perceived unfairness and loss of royalties potentially due to the RMI. It is understood the government has commissioned a study to evaluate the issue and to recommend a range of alternatives once the current contract expires in 2020.

STATISTICAL ISSUES

In former Gradual School USA reviews of the RMI, statistical availability has been accorded a high score. Since the start of the amended Compact, the RMI has developed a wide range of statistics that enable the monitoring of economic performance. The set of annual economic statistics is produced 11 months after the end of the fiscal year, and a new set of quarterly indicators is now being prepared in time for the regular session of the Nitijela in January and August. The annual statistical update is timed to coincide with the release of the government audits and in time for the Joint Economic Management and Financial Accountability Committee (JEMFAC) annual meeting. The most recent IMF Article IV staff review found “data provision to be broadly adequate for surveillance, though some shortcomings tend to constrain policy analysis, especially on trade statistics.” Weak data systems in the Tax and Customs office for both trade and gross revenue taxes inhibit comprehensiveness and timeliness, and they need to be replaced with modern systems. While the more frequent provision of biannual quarterly estimates is a welcome addition, the availability of provisional estimates earlier in the year to coincide with budget preparation would be a priority.

H. The Reform Agenda

PROGRESS WITH REFORM

During the amended Compact period, the RMI has entertained numerous reform initiatives that have failed to be successfully implemented. The expenditure proposals of the Comprehensive Adjustment Program (CAP) were not implemented, and although there has been some renewed interest in the tax-reform initiative, it will not happen during the current administration. While the SOE Act has become law, adoption of the “best practices” enshrined in the act requires effective implementation. There is no doubt the refinancing of the Marshalls Energy Corporation (MEC) debt under an ADB program (policy reform) loan had a beneficial result, but the fiscal targets of the program were not achieved. While the fiscal-responsibility and debt-management bill of 2012 failed to make progress, a Graduate School team assisted with developing a fiscal strategy including a responsibility framework in early 2019. While debated within government, it will need to be presented anew for consideration and possible modification to meet the priorities of a newly organized cabinet in January 2020.

THE LONG-TERM FISCAL GAP

In FY2016 and again in FY2017, the government enacted expansionary budgets increasing expenditures by $11 million (12 percent) and $22 million (19 percent), respectively. In FY2017 expenditures were sustained by the drawdown of prior MIMRA savings. In FY2018 total expenditures remained high and only fell by $3 million to accommodate the reduction in MIMRA resources of $14 million. While growth in other revenues was favorable, the result was a reduced fiscal surplus. At the current rate of fiscal expansion, the remaining fiscal space will soon be exhausted.

Possible large reductions in funding and the onset of the CTF distribution period in FY2024 indicate the need for a long-term fiscal strategy. Adjustments due to insufficiency in the size of the CTF are estimated to be about $7 million, or 3 percent of GDP. Potential loss of SEG and other key federal programs under a severe-case scenario represents a further $20 million, or a total of 12 percent of GDP. Using FY2015 as the base before the recent expansionary budgets indicates the scope for adjustment; real expenditures have risen by $27 million over the period FY2015–FY2018. However, the severe-case scenario and the need to support the SS system suggest that simply reverting to the FY2015 base may not be sufficient.

COMMITMENT TO REFORM

There is significant uncertainty on the level of funding after FY2023 and thus a need to revisit the reform agenda. Firstly, the RMI needs to act on the issue of fiscal responsibility by reversing at least a portion of the recent expansionary budgeted expenditures and allocating resources to the CTF and SS system in order to set the nation on a path of long-term fiscal sustainability. Secondly, the reform agenda outlined in the CAP, tax reform, and the SOE Act all remain highly relevant and in need of implementation. Despite announced commitments to reform, successive governments have tended to operate fiscal policy on the basis of appropriating all available resources; therefore, a break from past practice will be required to achieve lasting reforms and improved long-term economic and fiscal management. There is a need for donor support to provide the right incentives and conditions to foster a better result.

I. Economic Outlook

BASE-CASE PROJECTIONS INDICATE FAVORABLE ECONOMIC GROWTH PROSPECTS

After strong growth in FY2018, the economy in FY2019 is projected to maintain the momentum with continuing growth of 3.4 percent. Average GDP growth through the remaining amended Compact is projected at 1.7 percent, above the average growth of 1.2 percent during the first 15 years of the amended Compact. The improved performance reflects the boom in donor-funded infrastructure projects, full use of the Compact infrastructure grant and use of the backlog of funds. In FY2024, the first year in which the annual grant allocation switches to CTF drawdowns, the economy is forced to adjust and declines by 0.1 percent. Thereafter the economy resumes its steady-state growth of 1.1 percent.

On the fiscal side, revenues are projected to grow rapidly in the near term, with increasing use of the backlog of the Compact infrastructure grant and booming donor funds. In FY2024 Compact sector grants switch to CTF distributions and drop by 25 percent, reflecting an anticipated move by the JEMFAC to set distributions at sustainable levels. The SEG also terminates, and total revenues are projected to drop by $12 million, or 4.4 percent of GDP. Reflecting current policy, expenditures are projected to mirror the pattern of revenues. In FY2019 a fiscal deficit results, reflecting the rapid increase in the copra subsidy to support rural incomes. In FY2020 subsidies are set to fall to lower levels, and fiscal balance is restored and maintained through FY2023 although on a declining trend.

In order to address the rapid decline in revenues in the post–amended Compact era, the government has no alternative but to adjust. The main avenue of adjustment is to cut operating expenses on goods and services by two-thirds of the increase since FY2015, the level prevailing before the recent rapid fishing-fee-induced growth in expenditures. It is further assumed the government terminates further transfers to SS and the CTF. In FY2024 expenditures fall to match the reduction in revenues, and a fiscal surplus of 1.6 percent of GDP is attained. In essence, a significant part of the expenditure growth induced by booming fishing fees is squeezed out of the system. The projected fiscal surplus for FY2024 is maintained through FY2030 although at a declining rate.

FISCAL-RESPONSIBILITY SCENARIO

The impact of a fiscal-strategy and fiscal-responsibility framework is outlined in chapter 4 of the Review. The emphasis is on fiscal consolidation rather than on policies to promote private sector development. The reforms included in the program draw on prior initiatives such as the tax- and revenue-modernization effort and SS reform. The program includes the ongoing SOE reforms as part of the ADB-supported PFM initiative and elements of the prior Decrement Management Plan (DMP). The program includes establishment of a countercyclical reserve and additional funds for the CTF. Finally, it is assumed the donor community, ADB, World Bank and EU support the program through allocating a portion of their existing programs to budgetary support:

- Tax reform
- Countercyclical reserve
- Enhanced CTF contributions
- Sustained SS support
- SOE reform and adjustment
- Reform of the Majuro landowner utility subsidy
- Donor support through budgetary support

While the impact of the reforms on the economy imparts a small loss in GDP, 0.5 percent of GDP by FY2030, there are significant positive impacts on government net financial wealth. Net wealth accumulates significantly by 29 percent of GDP by FY2030. However, the fiscal-responsibility scenario represents an approach to fiscal management that has not been evident in the past. For the reforms considered here and the achievement of long-term fiscal sustainability, a new era and culture of fiscal and economic management is required. With the large current donor interest in the RMI, the coming changes in the Compact arrangements, and challenges posed by climate change, the reforms suggest that a coordinated approach between donors and RMI is needed. While the RMI has failed to adopt a reform agenda in the past, the current period of change may provide the incentive required.

1. Review of Economic Developments

The RMI economy performed well in FY2018 with 3.6 percent growth in GDP, slightly below the 4.1 percent attained in FY2017 but improving on the modest growth during FY2015–FY2016. During FY2017 the major driver of the improved performance was an increase in construction activity following a resumption in disbursements of the Compact infrastructure grant and more importantly the impact of a large fiscal stimulus. In FY2018 the fiscal expansion coupled with a good year for fisheries continued to be a major driver.

- Population in the RMI historically grew at very high rates, averaging 4.3 percent. This pattern changed radically by 2011, with the population census indicating the rate had slowed to 0.4 percent, a consequence of a reduction in fertility rates and the emergence of large out-migration to neighboring US territories, Hawaii and the US mainland.
- During the amended Compact, employment growth has averaged 0.7 percent annually, with the public sector growing by 1.2 percent and the private sector by 0.7 percent. The large fiscal expansion in recent years has enabled continuing job growth in the public sector, while private employment opportunities have been limited.
- Wages have grown modestly in the RMI, by 2.5 and 1.5 percent per annum in the private and public sectors, respectively, in the amended Compact since FY2003. However, once inflation has been considered, real wages have fallen in the two sectors by 0.1 and 1.0 percent, indicating declining standards of living.
- After a period of negative inflation in FY2015–FY2016 with falling world oil prices, inflation in FY2017 stabilized, recording a 0.0 percent change. In FY2018 inflationary forces remained modest and prices rose by 0.8 percent.
- Between FY1999 and FY2018, real GDP per capita expanded by an average rate of 1.7 percent in each year. In FY2018 gross national disposable income (GNDI) per capita was $6,177, which places the RMI in the World Bank's upper-middle-income range from $3,996 to $12,375.

1. Review of Economic Developments

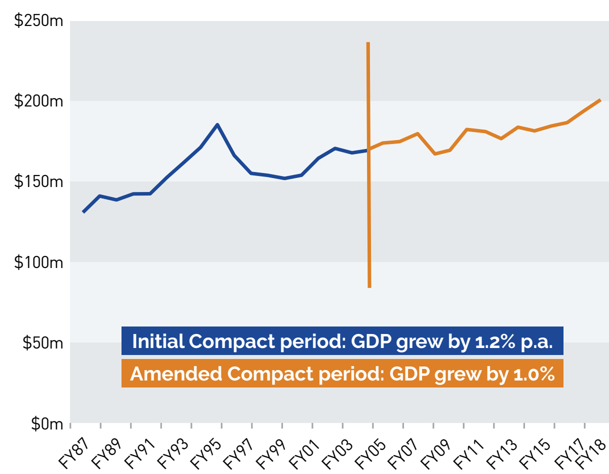
A. Gross Domestic Product, Growth and Structural Change

TRENDS IN ECONOMIC ACTIVITY

Long-run economic performance considered satisfactory: Long-run trends in the RMI economy are displayed in figure 1 and indicate that since FY1987, economic growth has averged 1 percent per annum. While this may appear to indicate a weak performance for a small remote resource-scarce atoll-based nation, it should be considered satisfactory. Long-run growth in the FSM averaged 0.7 percent over the same period, and in Palau it has averaged 0.8 percent since FY2000, both being economies with access to a wider resource base than the RMI.

Compact I dominates with implementation of development projects that subsequently failed to deliver any benefit: During Compact I, the RMI economy grew at the slightly more rapid rate of 1.2 percent but was punctuated by a sharp acceleration in growth in the mid-'90s. This reflected the issuance of medium-term bonds with repayment guaranteed through the "full faith and credit" provisions of the Compact, with repayments to be deducted from future Compact grants. The funds were invested in a series of risky development projects on the mistaken belief that these would enable the RMI to attain improved performance in the long term. Unfortunately, the projects failed to deliver the expected benefits. The economy went into a severe contraction in the late '90s as the nation was forced into repaying the debt and had reduced funds available to support government operations. A public sector reform program was executed with ADB support, entailing a large reduction in the number of civil servants, which, while restoring fiscal stability, led to economic contraction. The last few years of Compact I ushered in a more favorable period as the economy recovered in the run-up to the amended Compact.

Figure 1
Long-run growth of the RMI economy



Amended Compact ushers in a favorable period during the early period, FY2004–FY2007: FY2004 marked the start of the amended Compact. The RMI negotiated a favorable assistance package that increased funding by $10 million above the five-year period of Compact I (FY1997–FY2001). During FY2004 economic growth was weak, despite the more favorable conditions, due to the closure of the fish-loining plant and capacity constraints in using the additional fiscal resources (see figure 2). By FY2005 the capacity constraints were overcome and a substantial increase in Compact resources enabled the economy to expand. The private sector supported economic activity, with additional investment demand arising from the Compact infrastructure grant; the renovation of the Majuro airport; the construction of the international convention center, funded by the Republic of China (ROC); and the reconstruction of the Majuro fish-loining plant under new ownership. GDP grew by an annual average of 1.7 percent in the four years from FY2003 to FY2007.

Severe contraction in the economy during FY2008: By FY2008 the economy had peaked; GDP fell by 6.8 percent. The initial wave of Compact infrastructure-construction projects

Figure 2
RMI real GDP growth (percent)

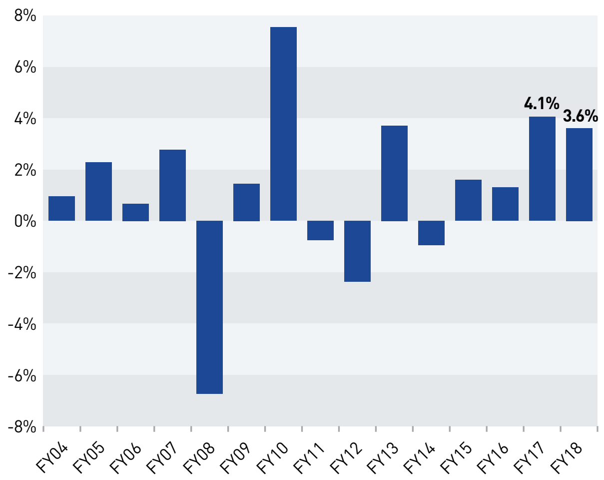
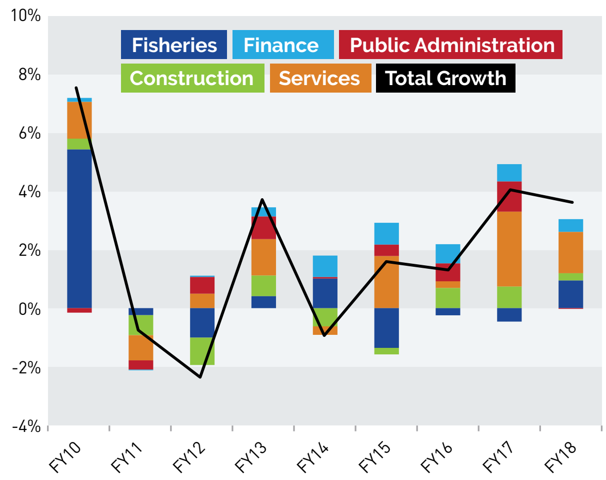


Figure 3
Contribution to economic growth by major industry



had come to fruition, and further expansion in government was no longer possible, as expenditures hit their ceilings. FY2008 also saw the end of rapid expansion in the world economy as fuel and food prices reached record levels. Inflation in the RMI climbed to 15 percent, eroding domestic real incomes and reducing demand for local business. Compounding these problems, the MEC underwent a severe cash flow crisis when fuel prices soared, requiring substantial cash infusions from the government. These forces prompted the RMI leadership to declare the first-ever "state of economic emergency" in late FY2008.

The economy recovers in FY2009–FY2010: In FY2009, while inflation eased back to 0.7 percent and many of the same forces exerted themselves, the year saw the start of an economic recovery and GDP grew by 1.4 percent. FY2010 turned out to be a boom period, as GDP grew by 7.6 percent; the reopened loining plant and the addition of new purse seiners to the fishing fleet accounted for 5.4 percent of the overall result (see figure 3 for major contributors to economic performance from FY2010 to FY2018).

After recovery, the economy enters a period of volatility and weak performance: During the next six years, FY2010 through FY2016, the economy displayed an erratic and lackluster path, oscillating from years of growth to contraction. Fisheries, manufacturing and the utilities sector exerted a negative influence on the economy of close of 1 percent each. Construction also performed weakly despite the airport FAA realignment project and was adversely affected by a moratorium placed on disbursements from the Compact infrastructure grant. The positive forces were represented in the finance, general-services and public administrative sectors, all of which contributed in excess of 2 percent.

Improved performance in FY2017–FY2018: In FY2017 and FY2018, economic conditions improved, and the economy grew by 4.1 and 3.6 percent, respectively. This reflects a resumption in disbursements of the Compact infrastructure grant and growth in public services due to expansionary fiscal policy, especially in FY2017, which recorded record levels of public expenditures. Fisheries activity contracted at Pan Pacific in FY2016 because of regulatory issues in conforming to international shipping regulations, but the issues appeared to have been resolved in FY2017. Despite an improved performance in Pan Pacific Fishing, the loining plant was at an all-time low and the fisheries sector exerted a negative influence on the economy. Performance in both fishing and loining improved at Pan Pacific in FY2018, exerting a positive influence on the economy.

GDP BY INSTITUTIONAL SECTOR

Private sector performance highly correlated with developments at Pan Pacific and public expenditures: Figure 4 elaborates on the story, indicating the performance of the private and government sectors and their contribution to the economy. The private sector, including financial institutions, has grown by an annual average of 1.9 percent[1] since the start of the amended Compact, above the economy-wide average for GDP of 1.0 percent. Private sector performance has been erratic and strongly influenced by developments in the fisheries sector, particularly the closing and opening of the fish-loining plant. Deducting the influence of fisheries, the private sector has largely remained stationary, indicating no trend growth, although in the last two years the private sector grew rapidly, reflecting the boom in public expenditures. On the other hand, the fisheries sector has grown on average during the amended Compact by 6.4 percent per annum.

SOEs are particularly important in the RMI because of high level of government subsidy: The SOE sector is particularly significant in the RMI because of the considerable number of public entities, high level of subsidy and burden on the fisc. Figure 5 provides an indication of recent trends since the start of the amended Compact (value added is measured at current producer prices without subsidies). The contribution of the SOE sector began to deteriorate in FY2003. Value added fell through FY2006 and reached a low in FY2008, primarily from poor performance in the energy sector. SOE value added has subsequently grown significantly, primarily because of the improved financial situation of the MEC but also because of improvements at AMI and the Ports Authority and growth at the Development Bank.

Figure 5
State-owned enterprise value added and subsidies

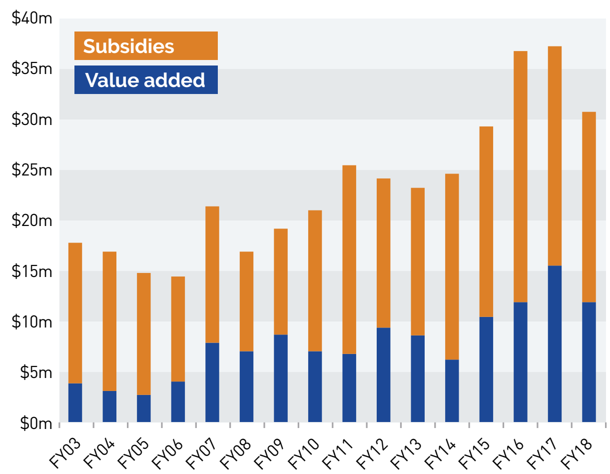
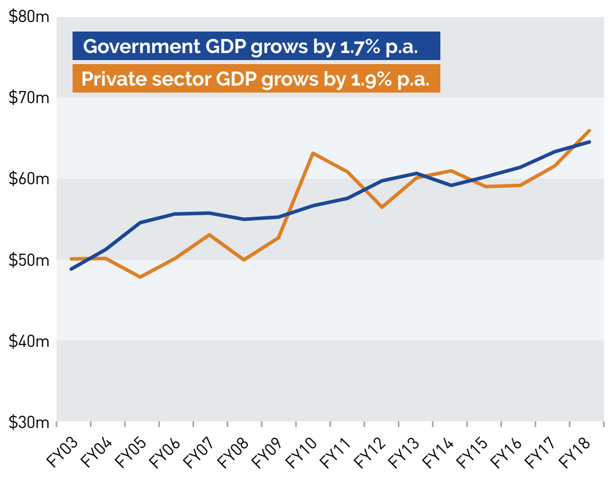


Figure 4
RMI constant-price GDP by private and public sector, FY2015 prices



Subsidies to SOEs have grown significantly: With the deterioration in the financial viability of many SOEs, the need for government subsidy increased. Between FY2004 and FY2006, the annual average level of government subsidy was $3.3 million. However, the level of subsidy is now much higher, averaging $13.1 million per annum during the last three years, FY2016–FY2018. This jump was due to a variety of forces but was heavily influenced by the impact of high energy prices on the financial position of KAJUR during the mid-2000s. The MEC also receives significant subsidy, more akin to a community-service obligation, for the provision of electricity in the atolls of Jaluit and Wotje. Subsidies continue to grow in support of AMI and, in the case of Tobolar, the copra-processing authority, have grown rapidly in recent times to subsidize outer-atoll incomes.

Subsidies to other SOEs formerly not required are now also necessary: The creation of the

1 Growth rates estimated from log-linear regression.

Marshall Islands Shipping Corporation (MISC) in FY2007 has required a growing level of subsidy, averaging in excess of $1.8 million during the last three years. The NTA formally returned a positive operating profit, but, since the installation of the fiber optic connection, it has also required support, with an average subsidy of $1.8 million during the last three years. The finances of the Marshall Islands Resort and Majuro Water and Sewer Company (MWSC) are also weak. While appearing to operate without subsidy, they receive hidden support through provision of electricity without charge.

SOE sector poses significant threat to fiscal stability: The impact of the rising levels of subsidies provided to the SOEs continues to be a major policy issue. Moreover, it has threatened the financial viability of the nation, as the government is faced with a decline in the real value of Compact grants. Chapter 5 of the Review provides continuing discussion of the SOE sector and selected enterprises.

National government grows rapidly at start of amended Compact, but growth subsequently moderates: For the national government of the RMI, the initial period of the amended Compact, FY2003–FY2006, saw rapid expansion averaging 9.1 percent, fueled by the infusion of funds from the amended Compact after the compressed state of fiscal policy at the end of Compact I. From this point, growth of the national government moderated and averaged 0.9 percent through FY2018. The lower trajectory reflects the underlying resource envelope of the amended Compact, the impact of the international financial crisis during FY2008–FY2009, and subsequent adjustments required to conform to teacher-certification requirements accompanying the Compact sector-grant awards for education. After the initial expansion of the national government, growth in the civil service has been moderate. While there have been periods that experienced cash flow shortages, civil-service growth and recruitment have been broadly sustainable.

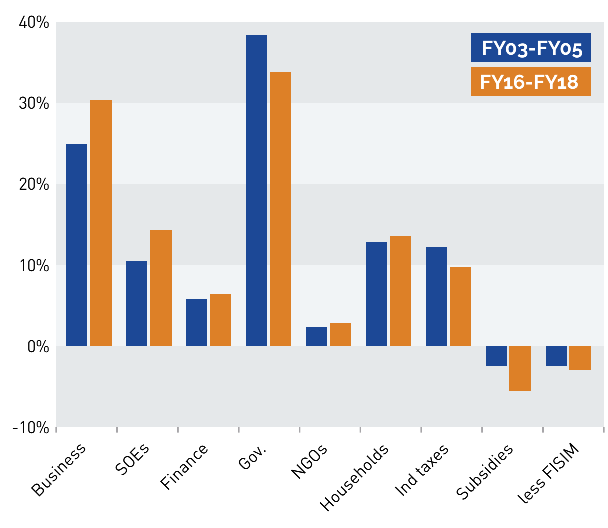
Government agencies grow rapidly as local government stagnates: While the national government of the RMI is the largest player in the general-government sector, public agencies and institutions, including the College of the Marshall Islands (CMI), and local government are also significant. Government agencies represented about 23 percent of the share of the national government in FY2018 and comprise the CMI and a set of other, smaller entities. Government agencies have grown rapidly by 5 percent per annum since FY2006, with the CMI being the major driving force behind the expansion. The two local governments—Kwajalein Atoll Local Government and Majuro Atoll Local Government—represented 19 percent of the size of the national government in FY2018. However, unlike the government agencies, the size of the two local governments in terms of GDP has remained largely unchanged since the start of the amended Compact.

Household contribution to GDP projected to mirror population growth: The household sector makes an important contribution to GDP, producing mixed incomes from copra, fishing and handicrafts. Nonmarketed production (subsistence) and homeownership are the main components and are estimated to increase in relation to population growth.

STRUCTURAL CHANGE

Share of private sector increases as government share declines: Summarizing the above discussion, changes in the structure of the RMI economy from FY2003 to FY2018 are indicated in figure 6. Given the recent growth of the fisheries sector, it is not surprising that

Figure 6
Structure of the RMI economy by institutional sector



the share of the private sector has grown from 25.0 percent (FY2003–FY2005 average) to 30.4 percent in the last three years (FY2016–FY2018). This represents a significant structural change, although the enclave nature of the sector and weak linkages to the rest of the economy need to be emphasized. Government has decreased its share from 38.5 to 33.9 percent, a significant reduction, with most of the reduction in the first half of the amended Compact.

Share of SOEs grows but is offset by increase in subsidies; taxes decline, reflecting weak regime: The increasing share of the private sector and reduction in government have been accompanied by a significant rise in the share of SOEs, from 10.5 to 14.4 percent. However, when the impact of the increase in subsidies is considered, the net change in contribution of the SOEs rose only by 0.7 percent. The remaining smaller institutional sectors—finance, nonprofits, and households, including subsistence and homeownership—have increased their shares. The drop in the share of indirect taxes reflects the outdated, inefficient nature and lack of buoyancy of the tax regime.

Early indications of a switch to private sector–led growth may be premature as booming sovereign rents and grant aid boost the public sector: During the first 10 years of the amended Compact through FY2013, the private sector accounted for an increasing share of GDP, suggesting a switch to private sector growth. This was mirrored by a significant reduction in the share of government. However, since that time, the large increase in natural-resource rents has enabled government to stem the decline. In the private sector, fisheries have displayed an important upward trend, but performance in the rest of the sector has been lackluster. SOE-sector performance has improved but remains a drag on development, constraining economic growth. While it might have been tempting to suggest that public sector–driven growth would come to an end, especially as the end of the amended Compact approaches, the boom in fishing fees and aid budgets suggests this might be premature.

INDUSTRY DEVELOPMENTS

Copra subsidies reach record levels in FY2018 and are set to rise in FY2019: Agriculture comprises two kinds: production for home consumption, with small sales to local markets; and production of copra, which provides income to the outer atolls. Subsistence production is estimated to vary in proportion to population change. Copra production has remained little changed since records began in 1951, but with large swings from year to year. Improved shipping services were introduced in 2007 with the creation of the MISC, an SOE, but this had little impact on production. The producer price of copra, which is set by government but implemented by Tobolar, another SOE, was $240 a short ton between 2003 and 2006 and averaged $541 a short ton in FY2013–FY2017. In FY2018 the average producer price rose to $962 a short ton, reflecting a political decision to increase grower prices to 50¢ a pound to enhance outer-atoll incomes. World market prices for coconut oil are highly volatile and generally significantly below the equivalent price paid to growers. The resulting loss incurred by Tobolar is financed by government through subsidy, which averaged $1.1 million per year between FY2004 and FY2014. In FY2015 the level of subsidy began to rise; it reached a record of $4.5 million in FY2018. In FY2019 grower prices have remained at 50¢ a pound, and government has made provision for financing of the subsidy of up to $12 million.

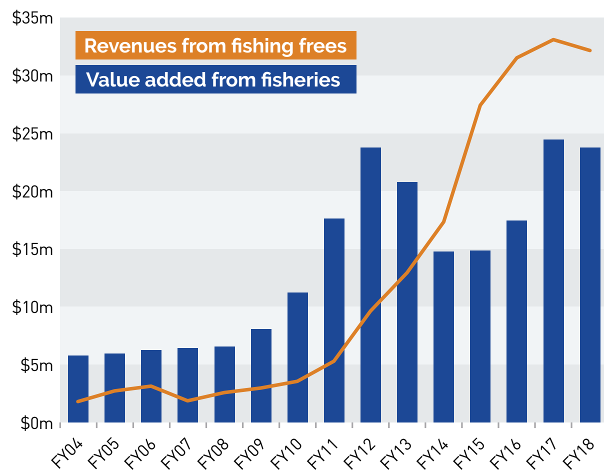
Operation of Majuro loining plant only viable through cross-subsidization from Pan Pacific's fishing operations: The fisheries sector in the RMI economy has been a strong driver of growth, in line with the economy's comparative advantage. However, growth has been erratic, reflecting the opening and closure of the Philippines Micronesia and Orient Line (PM&O) Processing Plant in FY2003 and replacement with the Pan Pacific Foods (PPF) operation in FY2008. The PPF loining plant (considered as part of the fisheries—not manufacturing—sector) operates at a loss, which is offset through access to RMI fishing rights. In 2010, when the recommissioned plant was operating at peak, production of loins was 3,919 metric tons. Production fell over the next five years through FY2015 but has subsequently stabilized at close to 2,000 metric tons. The average number of employees followed similar trends, declining in the initial years but stabilizing around 200. Operations at the plant are marginal and only remain viable through the cross-subsidy received from the lower fishing fees paid by PPF.

Structure of RMI fishing fleet: PPF initiated fishing activities with the launching of a first purse seiner in 2010, and two more boats were commissioned in 2011. A further two leased boats subsequently commenced operations but were replaced in 2019 by three domestically flagged vessels. In addition to the PPF operations, the sector consists of the Marshall Islands Fishing Venture (MIFV), a longline operation run by Luen Thai; four purse seiners operated by Koos; and Marshall Islands Fishing Company (MIFCO), a joint venture with one boat operated by Koos and the RMI government. The Central Pacific Fisheries Company (CENPAC) established operations in 2011 with two seiners, but these boats subsequently relocated to the FSM. It should be noted that the offshore longline operations of the MIFV, and the seiners operated by Koos, MIFCO and the CENPAC, are considered nonresident and are thus not part of GDP.

Fisheries' value added rises strongly, but the enclave nature of the activity means linkages to the rest of the economy are limited: In addition to the tuna fishery, there are numerous small operators exporting aquatic fish and producing for home consumption in the outer atolls. There is a small commercial-fishing market in Majuro. The impact of the recent developments, primarily with the reopening of the loining plant and the operation of new domestically flagged seiners by PPF, was a dramatic rise in the contribution of commercial fisheries to the economy during the FY2009–FY2012 period (see figure 7). Value added in current prices has risen from an average level of $5.8 million in FY2004 to $23.8 million in FY2018. While growth has been strong, the enclave nature of purse-seine operations means linkages to the rest of the economy are limited.

Fishing royalties grow strongly, reflecting the highly successful implementation of the PNA and the VDS: Figure 7 also indicates the growth in fishing royalties received by the RMI primarily from participation in the PNA through the VDS. While the value added generated from fisheries is part of GDP, fishing royalties are recorded as primary income from the rest of the world and form part of gross national income (GNI). The figure indicates the very rapid increase since the initiation of the VDS in

Figure 7
Commercial fisheries value added and fishing-fee revenues



FY2010. The floor VDS rate is currently $8,000 per day, but actual negotiated rates stand close to $12,000. The impact of the VDS on the budget and other fisheries-related issues are taken up in subsequent chapters.

The manufacturing sector consists of a few small local activities producing for the local market and Tobolar, the copra-processing plant. The contribution of general manufacturing to the domestic market is modest, and growth has mirrored local market conditions. Given the vertical integration between Tobolar and copra production, performance at Tobolar reflects that of copra production.

The utilities sector comprises three SOEs: the MWSC, the MEC, and KAJUR. Trend output of the MWSC has grown during the amended Compact as the capital, Majuro, has expanded. Electricity generation at the MEC and KAJUR has trended downward because of increasing tariffs, reflecting rising fuel costs.

The construction sector includes private business activities, operations of the Public Works Department and home construction. Private sector construction declined over the FY2006–FY2015 period, resulting from reductions in building projects and the moratorium placed on the use of the Compact infrastructure grant. In FY2013, however, there was an uptick in construction due to the FAA airport-realignment project. In FY2014 and

FY2015, private sector construction activity reverted to trend, but in the last three years, FY2016 through FY2018, construction improved with resolution of issues of compliance with the Compact infrastructure grant. With large donor-funded projects in the pipeline, construction is expected to be a booming industry over the medium term.

The wholesale and retailing sector is dominated by retailing to households and remained largely stationary in the early years through FY2007. In FY2009, output tanked, reflecting the impact of the recession and rapid inflation, and it remained depressed through FY2015, when the large fiscal expansion ignited strong demand, which has continued in the last few years. The MEC operates a fuel farm and sells fuel to fishing enterprises. Output fell precipitously in FY2007 as the MEC underwent financial collapse. It subsequently improved, reverting to the levels attained at the start of the amended Compact. However, since FY2015 the volume of sales contracted as fishing enterprises shifted purchasing to high-seas operators.

Performance in the hotel-and-restaurant sector has been disappointing: Private sector operators suffered a prolonged period of decline through FY2016, but this seems to have bottomed out, with some small improvements in the last two years. The Marshall Islands Resort (MIR), an SOE, has managed to increase its share at the expense of other private operators, but the combined output of the private and SOE sectors has been disappointing, despite the potential of the Marshall Islands as a tourist destination.

The transport-and-communications sector comprises a series of general private sector–operated services and several publicly owned operations. The latter include the Marshall Islands Ports Authority (MIPA), the MISC, AMI and the NTA. The various components of the industry grouping have displayed varying trends. Combining them, a downward trend emerges during the initial years of the amended Compact period, but, since FY2008, output has improved.

The finance sector has performed strongly in recent years: The finance sector, comprising the commercial banks, the development bank, insurance agents, financial auxiliaries and the Marshall Islands Trust Company, has performed well during the amended Compact, growing by an average annual rate of 5.3 percent. From the start of the amended Compact through FY2013, output was suppressed, but since that time it has expanded rapidly. In FY2011 and FY2012, output in the commercial banking sector stagnated, reflecting the large payouts to Kwajalein landowners and reductions in deposits and repayment of loans. However, output in all components of the financial sector has grown rapidly since FY2013.

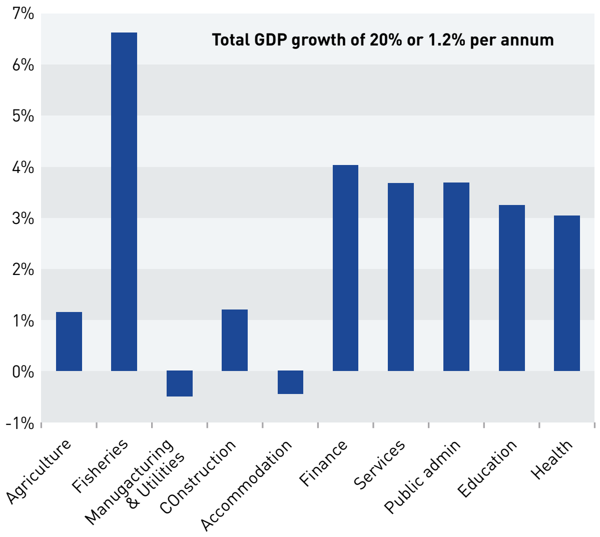
Public administration, comprising the national government, agencies and local government, remained largely stagnant during the early years of the amended Compact but since FY2011 has displayed a higher average growth rate of 3.4 percent per annum, reflecting the expansionary fiscal policy.

The education sector comprises the government sector, the CMI, the USP and nonprofits: With the switch to the sector-grant approach in Compact funding, the provision of government services to education expanded strongly in the initial years. However, since FY2013 output has contracted, in part reflecting the need for teacher certification as required under the Compact-sector awards. In the case of the college, which is a significant beneficiary of Pell grants, services have expanded by nearly 3 percent, and it has been an area of strong public sector growth. The USP in Majuro has also grown rapidly since its establishment.

Health services have grown by an average trend of 1.9 percent during the amended Compact, again reflecting the emphasis on health care during the amended Compact.

Public services and fisheries are the main drivers of economic growth and are responsible for over 75 percent of the total: To conclude this section, figure 8 summarizes and indicates the major drivers of the RMI economy during the amended Compact period. The economy grew by a total of 20 percent, or by an annual average rate of growth of 1.2 percent. The combined activities of public administration, education and health were responsible for 10.0 percent of this total, much of it in the early part of the amended Compact. Fisheries has been a very strong driver, responsible for more than any other sector, representing 6.6 percent, or 20 percent of the total growth. However, while the impact of the loining plant has been significant,

Figure 8
Contribution to GDP growth by industrial sector between FY2003 and FY2018



the influence of purse-seine operations on the domestic economy is minor, given that they have employed few Marshallese, the profits are returns on foreign investment, and operational costs are largely incurred offshore. Construction activity has not played a major role in economic growth and has not changed over the period. The absence of growth reflects the recent moratorium placed on the use of the infrastructure grant, although this has now been lifted and a more active sector can be anticipated in the future, especially construction originating from the booming aid sector. Of special note is the negative contribution of hotels and restaurants, considered to be one of the RMI's sectors of comparative advantage. Finance has made an important contribution to overall growth, reflecting the proactive stance of the local bank.

B. Population, Incomes, Distribution and Poverty

POPULATION AND MIGRATION

Population growth falls significantly: Population in the RMI has historically grown at a very high rate. From 1980 to 1988, in the years leading up to Compact I, the annual average rate of growth was 4.3 percent (table 1). The population in Majuro grew at 6.6 percent, reflecting the emergence of a modern economy and the availability of jobs and public services, such as health and education. Population growth in Ebeye was slightly below the nation's average. In the outer atolls (the "other" category), population growth was below average as a result of internal migration. This pattern changed radically between the next two census points, 1988 and 1999. Population growth slowed significantly to 1.5 percent, a consequence of a reduction in fertility rates and the emergence of large out-migration to neighboring US territories, Hawaii and the US mainland under the migration provisions of the Compact. The results of the 2011 population census indicated that these trends continued, and overall population growth slowed to 0.4 percent. Population growth in Majuro also slowed, while in Ebeye it was largely static, and figures from the outer atolls indicate the emergence of depopulation. Although overall population growth has been moderated by out-migration, inward migration from Asia has been significant.

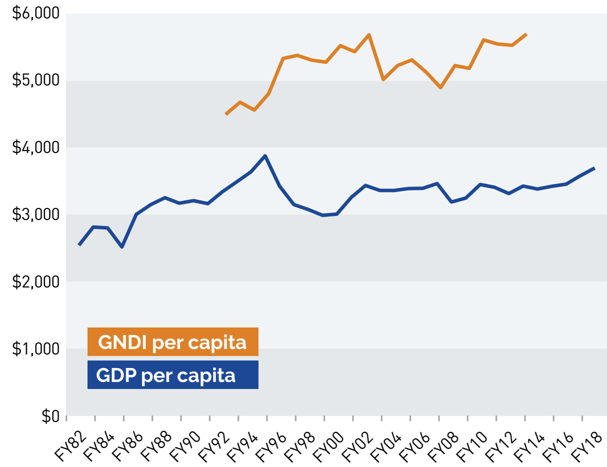
Migration provides safety valve for Marshallese with limited job opportunities: Limited job opportunities and the depressed state of the economy during the late part of Compact I encouraged large-scale migration to seek employment opportunities and better remuneration in the United States. Migration plays an equilibrating role: if incomes fail to grow, outward migration compensates, improving the average income levels for those remaining. However, outward migration will have a distorting impact on the local economy if it is achieved through a loss of economically active and skilled individuals. Such a loss of human capital would reduce the long-term productive potential of the economy.

Migration to the United States estimated at 1.7 percent: Table 2 provides further information on current migration rates and net movement of passengers between the RMI and various US destinations. Since the destination of nearly all flights originating within the RMI is a US point of entry, the figures provide a very useful indicator of net migration. However, the quality of the data has deteriorated since 2012, as subsequent figures indicate an untenable reverse flow. Restricting the analysis to the period up to 2012, the table indicates the average rates of migration since 1990 in three groups: expansionary phase of Compact I, contractionary phase and amended Compact. The table confirms the reduction in population growth indicated by the census data between 1990 and 2010, which is the result of increasing out-migration. The outward migration rate of 0.8 percent during the early Compact years accelerated to 2.4 percent during the depressed era of Compact I and continued at the lower rate of 1.5 percent during the improved period of the amended Compact. The table also implies that out-migration from Majuro has been more rapid than from Kwajalein.

REAL INCOMES

GNDI per capita in FY2018 was $6,177, 52 percent higher than GDP per capita: Figure 9 indicates the changes in constant-price GDP and real GNDI per capita in 2004 prices. Real GNDI includes the primary and secondary incomes received and paid to the rest of the world. The major differences between the two measures are the compensation of Marshallese workers at the Kwajalein base, fishing royalties, rent received by Kwajalein landowners, and the receipt of current transfers from the United States and other donors. (See the section "Balance of Payments" for a list of primary and secondary income flows.) The GNDI estimates begin in FY1997 and indicate a far higher level of disposable incomes when the additional flows are taken into account. In FY2018 GNDI per capita was $6,177, which is 52 percent higher than the current-price GDP per capita of $4,056.

Figure 9
GDP and GNDI per capita, constant prices 2015



GDP PER CAPITA: REAL INCOMES

GNDI per capita in FY2018 was $6,177, 52 percent higher than GDP per capita: Figure 9 provides a clear picture of the developments in average real incomes. The advent of the Compact marks a clear and significant improvement in GDP per capita during the run-up to and early years of the Compact. Growth was boosted by the new receipts of Compact funds and the series of bond issues that enabled the nation to fast-track public expenditures (including embarking on a series of risky public projects and ventures). However, the gamble on public sector involvement in productive activities did not pay off. The nation was forced into a difficult period of decline, as the economy adjusted to a low level of net aid transfers, which had been depleted by the need to repay the former extravagances. In 1999 matters improved, as fiscal stability was

Table 1 Population by major centers and population growth, 1987–2011

	Population				Population Growth			
	Total	Majuro	Ebeye	Other	Total	Majuro	Ebeye	Other
1967	18,925	5,249	3,540	10,136	3.3%	4.9%	11.9%	0.8%
1973	25,045	10,290	5,123	9,632	4.8%	11.9%	6.4%	-0.8%
1980	30,873	11,791	6,169	12,913	3.0%	2.0%	2.7%	4.3%
1988	43,380	19,664	8,324	15,392	4.3%	6.6%	3.8%	2.2%
1999	50,840	23,676	9,345	17,819	1.5%	1.7%	1.1%	1.3%
2010	53,158	27,797	9,614	15,747	0.4%	1.5%	0.3%	-1.1%

Source: Census reports

restored with new donor assistance, repayment of the debt and a favorable financial outcome of the amended Compact negotiations. Between FY1999 and FY2018, real GDP per capita expanded by an average rate of 1.5 percent in each year. In FY2008 and FY2009, GDP per capita faltered and took a downward turn, as the economy felt the negative impact of the international financial recession. The upward trend resumed in FY2010, and by FY2018 GDP per capita was close to but still 5 percent below the level attained 23 years before in FY1995.

REAL GNDI PER CAPITA

GNDI per capita in FY2018 was $6,177, 52 percent higher than GDP per capita: Figure 9 also includes the trend in GNDI per capita from FY1997 onward. Between FY1999 and FY2001, the level of grants rose rapidly, reflecting the initial receipt of grants from the ROC and the increase in Compact I grants after finalization of the repayment of the earlier medium-term note issues. Real GNDI per capita rose by 17 percent in two years. However, between FY2001 and FY2012, real GNDI per capita stagnated (apart from a couple of peak years) as a result of relatively constant levels of nominal grants and Kwajalein receipts but an increasing level of dividend outflows from growth in fishing activity. During the six years through FY2018, with the rapid increase in fishing royalties, GNDI per capita rose by 2.6 percent per annum, surpassing the previous highest level, attained in FY2007. The recent rapid benefits from the PNA have pushed GNDI on an upward path. However, the recent growth in fishing royalties has probably reached a cap, and the long-run trends are likely to reassert themselves.

DISTRIBUTION AND POVERTY

A UN report in 2009 noted that while abject poverty, starvation and destitution are not yet present in the RMI, there are clear signs that certain groups are facing increasing hardship: While the information and analysis on distribution and poverty in the RMI is dated, it remains relevant. In the ADB's 2002 Assessment of Hardship and Poverty, the 2005 Social and Economic Report, and the 2009 National Millennium Development Goals (MDG) Progress Report, prepared by the United Nations Development Program (and EPPSO), it is noted that while abject poverty, starvation and destitution are not yet present in the RMI, there are clear signs that certain groups are facing increasing hardship. The RMI is demonstrating mixed progress on MDG1 (eradicating extreme poverty and hunger), and there are growing concerns over high unemployment, financial hardship (including declining real incomes coupled with large consumer debt), hunger and poor nutrition. The 2019 Household Income and Expenditure Survey currently in the field should provide a very important source and update of information on distributional and poverty issues.

Distribution of income in urban centers is higher than that in outer atolls, but incomes in the nuclear-affected islands are substantially above other outer atolls: According to 2011 census data, 41 percent of outer islanders have an income of less than a dollar a day (in 2011 prices). Figure 10 provides an overview of average per capita cash income in the various atolls of the RMI. The data exclude subsistence production and homeownership, which are usually included in the definition of income. In the outer islands, subsistence

Table 2 Net movement of air passengers between the RMI and US ports of entry and percent population

	1990-1996			1997-2003			2004-2012				
	Net departures	Population	Net migration	Net departures	Population	Net Migration	Net departures	Population	Net migration	GDP per capita FY03–FY13	Total migration FY03–FY13
Kwajalein	-25	8,775	-0.3%	-211	9,338	-2.3%	-81	5,786	-1.4%		
Majuro	-360	21,408	-1.7%	-970	24,011	-4.0%	-823	27,017	-3.0%		
RMI	-384	46,448	-0.8%	-972	50,234	-1.9%	-904	52,123	-1.7%	0.2%	-7,836

Source: US Department of Transportation "TRANSTATS" database

Notes: Population estimates based on average projected levels between census points
Only includes air passengers to/from RMI and US airports (Guam, Hawaii, Saipan).
Passengers to/from RMI and other countries (e.g., FSM) are excluded.

Figure 10
Average household income by island, 2011 population census

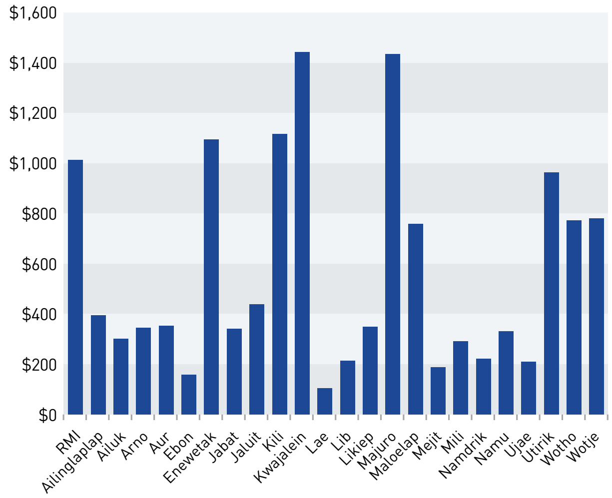
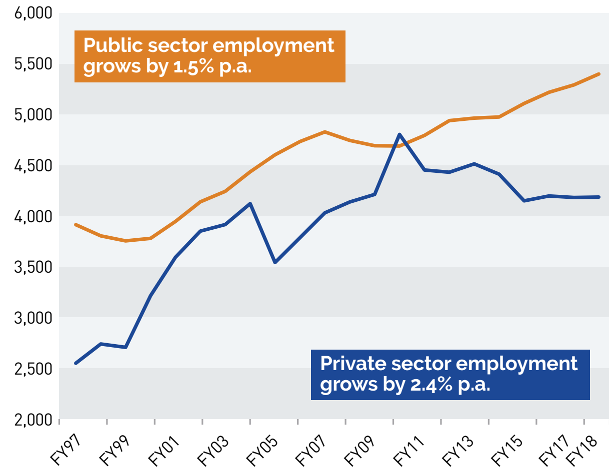


Figure 11
Employment in the private and public sectors



production compensates for the lack of cash income, and the emerging picture of income distribution is thus more extreme than the reality on the ground. Economic activity clearly differs between the urban centers of Majuro and Kwajalein—constituting the bulk of the nation's cash economy and labor market—and the outer atolls. Cash incomes in Majuro and Kwajalein are three times those of the outer atolls. However, within the outer atolls, the cash incomes of the nuclear-affected communities of Enewetak and Kili are substantially above those in the other islands. In the non-nuclear-affected islands, average per capita incomes range from $104 a year on Lae to $758 on Maloelap. Clearly, the lack of income-earning opportunities has provided a strong incentive to migrate to the two major urban atolls and, externally, to the United States.

C. Employment, Earnings and Wages

EMPLOYMENT

Employment estimates are derived from SS data: Figure 11 reflects recent trends in employment, based on quarterly data collected by the Marshall Islands Social Security Administration (MISSA) and adjusted by the EPPSO. The figures are estimated from the returns submitted to the MISSA by employers. Employment is measured by a count of individuals who made contributions during the quarter, regardless of how many days or hours each may have worked. The figures thus tend to overstate employment levels but are considered to be an accurate indicator of trends.

Private sector employment expanded during the initial years of the amended Compact but has fallen since FY2010: In the years running up to the amended Compact, there was significant growth in private sector employment. This reflected both the opening of the original PMOP loining plant and strong growth in retailing and transport. At the start of the amended Compact in FY2005, employment in the private sector fell by 14 percent (581 employees) with the closure of the PMOP loining plant to a level of 3,540. However, in the subsequent period, from FY2005 to FY2010, private sector employment resumed the prior expansion, despite the negative impact of the financial crisis. In FY2006 and FY2007, construction activity created strong additional demand for labor. In FY2008 the fish-loining plant was reopened by Pan Pacific Foods, and a daily average of 473 jobs was attained in FY2010. However, the supply of labor to the plant contracted between FY2011 and FY2018, and the daily average fell to 201. The labor shortages at the plant and falling construction demand led to a reduction in private sector employment in FY2011, and levels have fallen by an annual average of 1.7 percent over the last eight years, although private sector employment has stabilized in the last three years with resumed construction activity.

Public sector employment has provided a growing source of employment since the late 1990s: At the end of the 1990s, public sector employment contracted, reflecting the large fiscal adjustment required by the third and final step-down of the original Compact. However, from the low level in the late 1990s, public sector employment expanded strongly beginning in FY2000 and peaking in FY2007. Public sector employment (including public enterprises, agencies, and local and central government) grew by 29 percent between FY1999 and FY2007, at an annual average rate of 3.2 percent. Between FY2007 and FY2010, public sector employment contracted under tight fiscal conditions, but with greater resource availability it grew by an annual average rate of 1.8 percent between FY2010 and FY2018.

Employment from all sources including the Kwajalein base has expanded by 1.7 percent since the late 1990s: Figure 12 shows the overall rate of job creation since the late 1990s from all institutional sectors, including the US military base at Kwajalein. After a period of stagnation in the late 1990s, total employment expanded very rapidly through the start of the amended Compact. The closing of the loining plant in FY2004 and reopening in FY2010 led to sizeable dips and spikes in the series. In the subsequent period, FY2010 through FY2015, the series was dominated by the global financial crisis, reduction in employment at the plant, and retrenchment at the Kwajalein base, with employment remaining static. In the last few years, although private employment has been stagnant, the public sector and military base have had an overall positive impact.

The structure of employment: Figure 13 indicates the structure of nongovernment employment in FY2018, excluding public administration, education and health. The wholesale-and-retail sector (34 percent) employs the greatest number, with fishing-related activities having made a significant contribution (11 percent) since the reopening of the loining plant in 2008. Other industries, such as banks and real estate (6 percent), hotels and restaurants (6 percent) and construction (11 percent), provide much of the nation's private sector employment. Manufacturing and agriculture ("others") are insignificant employers. The Kwajalein US base is included in the data set and represents a significant proportion of employment (16 percent). Employment at the base was projected to fall by 669 jobs out of a total of 1,241 in FY2006 because of advances in technology (such as the recently completed fiber optic connection) that enable operations to be conducted from the US mainland. However, current data indicate that the original anticipated reduction has been much less severe than expected and that jobs have actually fallen by only 142.

Figure 12
Total employment in the economy

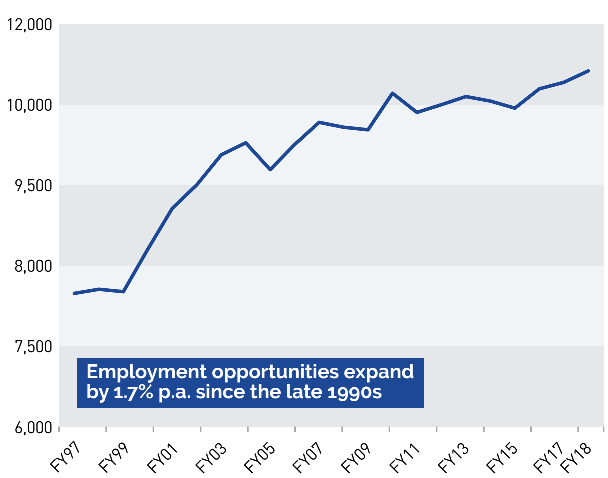


Figure 13
Employment in the private sector by major industrial sector, FY2018

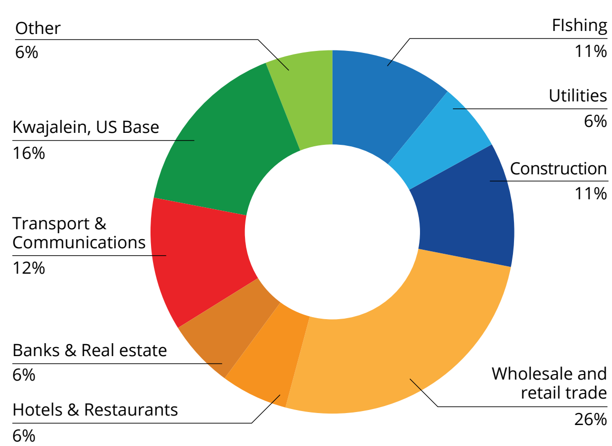
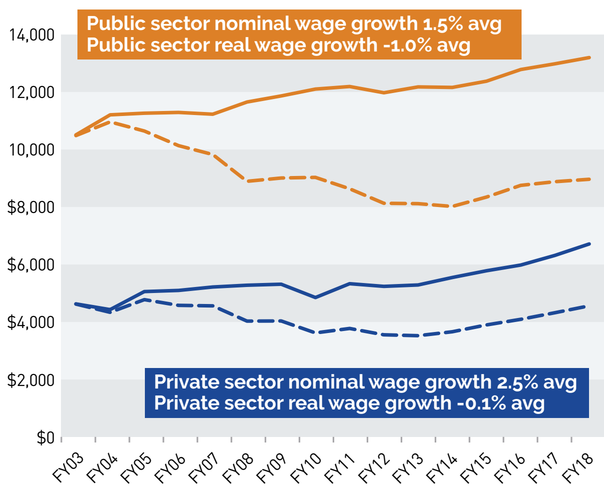


Figure 14
Nominal and real wage rates by major institutional sector



WAGE RATES

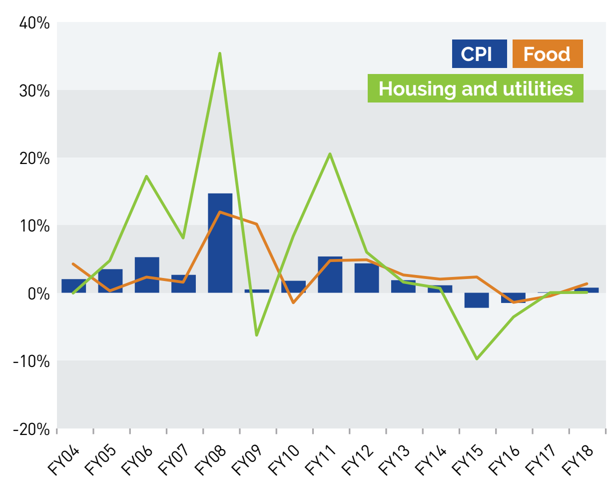
Real wages in the public sector have fallen, while in the private sector they have remained static, reducing the differential between the sectors: The data on nominal and real wage rates are derived from dividing the MISSA-reported earnings levels by employment numbers. Although this is not an exact estimate of wage rates, it should closely approximate the changes in wage levels. Figure 14 reveals a series of interesting trends. First, private and public sector wages have grown over the period by 2.5 and 1.5 percent, respectively. However, real wages (i.e., discounting for the impact of inflation) have fallen by 0.1 and 1.0 percent, respectively. The difference between the nominal and real series is 2.5 percent and reflects the average rate of inflation during this period. Clearly, there has been an erosion of real living standards during the amended Compact period. From figure 14 it is easily seen that average public sector wages are significantly higher than those in the private sector. However, it is not possible to conclude that public sector wage rates for similar skills are higher than in the private sector. The data indicate that the wage differential has narrowed during the period, from 127 percent in FY2003 to 97 percent in FY2018, which is a move in the right direction.

D. Prices

Inflation accelerates dramatically in FY2008: Figure 15 indicates trends in the consumer price index (CPI) for selected commodity groups since FY2004. After relatively modest rates of inflation through the end of 2007, consumer prices rose at alarming rates in FY2008. Clearly, the most dominant price change has been in the housing-and-utility section of the CPI, reflecting the impact of higher utility prices, which rose by 35 percent during the year. The changing environment confronting the MEC required large adjustments in electricity prices because of both a hike in world fuel prices and a need to charge fees more closely related to the basic costs of operations. Meanwhile, the food section of the CPI, reflecting the increases in world food prices, rose by 12 percent. The combination of these forces caused the overall CPI to rise by 15 percent in FY2008.

Inflation turns negative in FY2015 and FY2016, with prices remaining unchanged in FY2017 and rising modestly by 0.8 percent in FY2018: In FY2009 fuel prices moderated significantly to levels below those of FY2008, and food prices followed suit, falling in the subsequent year; overall inflation was 0.5 percent in FY2009. FY2011 saw a brief period of rising prices as inflation reached 5.4 percent, but this moderated in the subsequent three years through FY2014. With the large reductions in

Figure 15
Change in CPI by selected major commodity groups



fuel prices in FY2015, inflation turned negative and fell by 2.2 percent, as utility prices fell by 10 percent and transport prices by over 3 percent. The same forces exerted themselves in FY2016, and inflation recorded a negative 1.5 percent. In FY2017 nearly all prices remained unchanged and the CPI recorded no change. During FY2018 inflation remained modest, with prices rising by 0.8 percent for the year.

2. The External Sector

Deficits in goods and services are matched by positive outcomes on the primary and secondary income accounts. In essence, the imports of goods and services are financed out of positive receipts from earnings of Marshallese workers at the Kwajalein US base, rent of the base, fishing-fee royalties, and Compact and other aid transfers. The current account in the early years of the amended Compact through FY2013 was largely in balance apart from exceptional years. In the last four years, the significant rise in sovereign rents and reduction in fuel prices have been associated with a positive balance on the current account.

- RMI external debt remains significant and was characterized by the IMF in a recent debt-sustainability analysis (DSA) as reaching levels that placed the RMI at a "high risk of debt distress." Nevertheless, external debt continued to decline as a percentage of GDP, falling from 72 percent of GDP at the start of the amended Compact to 33 percent in FY2018.
- As a result of being designated as being at "high risk of debt distress," the RMI has now been accorded "grant only" status by the World Bank and ADB and is no longer eligible for concessionary-loan finance. This has both benefits and costs, but it ushers in a period of an enforced declining ratio of debt to GDP as existing loans are repaid.
- From the start of the amended Compact through FY2007, the real effective exchange rate (REER) remained largely unchanged, but, with a significant increase in inflation in the RMI due to rising fuel and food prices, the REER spiked in FY2008. The REER has subsequently depreciated, but it has not adjusted downward to its prior level.

2. The External Sector

A. Balance of Payments

Exports dominated by fish products and fuel re-exports: The current account of the balance of payments (BoP) is presented in abbreviated form in table 3 and in more detail in the statistical appendix. Exports comprise three major items: fuel re-exports (MEC offshore fuel sales), fish and coconut products (there are a few other, minor items). Up through FY2008, fuel re-exports were the major item of exports, but they have declined recently with the drop in fuel prices and more competitive pricing of high-seas refueling for purse-seine operators. In FY2009, with the reopening of the fish-loining plant and subsequent commissioning of new purse seiners by PPF, fish exports rose. They hit a peak in FY2012, reflecting high fish prices, fell in subsequent years with lower fish prices and rose again to close to their former levels in FY2018. In FY2016 Pan Pacific underwent regulatory issues in conforming to international shipping regulations, but these appear to have been resolved, allowing production to return to former levels.

Retained imports appear to have maintained a stable share of GDP: Imports free-on-board (f.o.b.) less fuel imports have maintained a relatively stable share in relation to GDP after accounting for exceptional items. During the amended Compact, nonfuel imports have averaged between 35 and 40 percent of GDP. FY2010 was an exceptional year, when nonfuel imports/GDP rose to 45 percent because of an increase in imports of purse-seine fishing vessels by Pan Pacific. Retained fuel imports excluding re-exports at present-day prices are close to 10 percent of GDP, bringing the ratio of total imports to GDP to about 50 percent. However, without greater product detail on the composition of imports, it is difficult to be precise.

Lack of comprehensive import statistics hinders analysis of the RMI economy: Import data have improved in recent years, but the lack of information by commodity is a major weakness in the nation's statistical systems. Recent investigations by the RMI customs division suggest adopting standard customs software such as Asycuda would considerably improve information flows and enhance compliance.

Services: The services account on the receipt side comprises a series of small items: processing and trans-shipment of fish owned by nonresidents; travel expenses of visitors to the RMI, port facilities, telecommunications and others. In total, these flows were static during the initial years of the amended Compact, but they have shown signs of growth from FY2009 onward. On the payment side, the large figure for freight and postal services represents the adjustment made to imports for cost, insurance and freight (c.i.f.) to estimate imports on an f.o.b. basis. Payments for passenger services represent payments for air travel; and construction services reflect payments for a new fiber optic connection to the RMI. The remaining item, "other," includes personal travel expenses overseas, business services, medical referrals and technical assistance (TA). Overall payments for services have displayed a gradual upward trend of 3 percent during the amended Compact.

Compensation of workers at the Kwajalein base is an important element of primary income: On the primary income account, there are several important items: compensation of Marshallese workers on the Kwajalein US military base, receipts of rent under the Compact by the Kwajalein landowners, ship-registration fees, and fish-license fees. With the reduction of workers at the Kwajalein base, earnings declined after the peak in FY2006, but the impact has not been as adverse as initially feared, and the value of earnings in the last two years has exceeded that at the start of the amended Compact. Landowner rent receipts under the Compact are determined by treaty and subject to partial (two-thirds) inflation adjustment.

Fees collected from the TCMI have grown in recent years, but whether the RMI receives a fair return is an important policy issue: Fees collected from the ship and corporate registry by the TCMI are small but have grown strongly since FY2006, reflecting changes in the terms of the contract with the company managing the registry. The actual value of receipt of fees by the TCMI has been a closely held secret, and whether the RMI receives a fair share of the earnings is taken up as a special policy issue in the policy chapter of this review.

Fish royalties have grown rapidly in the last few years: Fish-license fees have grown rapidly in recent years as a result of the implementation of the PNA and operation of the VDS. Through FY2010 fishing royalties averaged $2.7 million,

Table 3 Balance of payments, current account, FY2010–FY2018

(US$ millions)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Current account balance	-28.7	1.8	-0.8	-11.7	6.3	31.8	32.4	16.0	16.5
Goods and services balance	-117.1	-86.3	-82.0	-104.1	-89.0	-86.1	-82.7	-94.9	-99.2
Goods balance	-84.1	-51.2	-44.4	-65.5	-55.8	-52.9	-49.3	-54.4	-61.9
Exports of goods	43.7	70.1	81.7	76.2	69.5	59.0	51.5	60.2	63.3
Re-exports	27.1	34.5	37.1	36.8	38.6	29.3	20.6	18.2	22.2
Fish 1/	13.9	31.6	41.3	35.9	28.0	26.7	27.0	37.3	38.0
Other	2.7	4.0	3.3	3.5	3.0	3.0	3.9	4.7	3.1
Imports of goods f.o.b.	127.7	121.3	126.1	141.8	125.3	111.8	100.9	114.6	125.2
Services balance	-33.0	-35.2	-37.6	-38.6	-33.2	-33.3	-33.4	-40.5	-37.3
Exports of services	17.1	18.3	18.8	20.0	22.6	22.3	21.8	23.2	26.2
Fish processing	3.7	4.3	4.5	4.9	6.1	5.1	4.8	4.8	4.8
Travel	6.0	6.4	6.6	7.1	7.8	7.7	7.7	8.5	10.8
Other	7.3	7.5	7.7	8.0	8.7	9.5	9.3	9.9	10.6
Imports of services	50.1	53.4	56.4	58.6	55.9	55.6	55.1	63.6	63.5
Transport	26.2	29.5	32.1	34.1	32.2	31.0	29.1	32.3	33.7
Freight and postal services	15.2	18.5	19.5	21.7	20.0	16.9	15.7	17.4	19.3
Passenger services	10.9	11.0	12.6	12.4	12.2	14.0	13.4	14.8	14.4
Construction services	2.9	1.3	~	~	~	~	~	~	~
Other	21.0	22.6	24.3	24.5	23.7	24.6	26.1	31.4	29.9
Primary income balance	35.9	37.0	29.3	35.8	45.4	63.5	62.0	60.6	61.3
Primary income, inflows	51.4	58.7	58.4	63.3	68.2	84.2	86.1	91.6	93.6
Compensation of employees	18.4	18.2	17.8	18.4	18.5	19.4	21.0	22.3	23.0
Rent receipts for use of Kwajalein land	16.8	16.9	17.0	17.5	18.0	20.9	21.2	21.4	21.7
Ship-registration fees	3.0	3.8	4.0	4.0	4.8	6.0	6.1	7.3	7.3
Fishing-license fees 4/	3.5	7.9	7.3	10.9	17.3	25.7	25.3	26.4	26.3
Dividends and interest	8.0	10.5	10.2	10.5	7.8	9.7	10.2	11.9	13.3
Other	1.7	1.5	2.0	1.9	1.8	2.4	2.3	2.3	2.0
Primary income, outflows	15.5	21.8	29.1	27.5	22.7	20.7	24.1	31.0	32.2
Secondary income balance	52.5	51.1	52.0	56.7	49.9	54.4	53.0	50.3	54.4
Secondary income, inflows	57.9	57.3	59.0	64.5	58.5	63.5	63.1	61.0	66.5
Government grants	47.6	46.6	46.8	52.4	45.7	49.1	50.0	47.3	52.7
Compact current grants	32.3	30.9	31.7	29.5	29.1	33.1	32.2	31.2	31.8
Other budget and off-budget grants	15.3	15.7	15.1	23.0	16.6	15.9	17.8	16.1	21.0
College of Marshall Islands	4.3	4.6	6.0	5.1	5.9	5.1	4.4	5.2	5.4
Other 2/	6.0	6.1	6.3	6.9	6.9	9.4	8.7	8.4	8.4
Secondary income, outflows /	5.4	6.1	7.0	7.8	8.6	9.1	10.1	10.7	12.1

1/ Pelagic fishing vessels operated economically from abroad are treated as nonresident; thus, their sales are not included in exports in the main dataset.

2/ Mainly households

but they grew rapidly to $26 million in FY2015 and have stabilized at that level in the last four years. Further rapid growth in fish royalties is not anticipated, and it is expected that receipts will gradually grow over time.

Dividend payments on FDI form the major element of primary income payments: On the payments side, dividends paid on FDI are the major component and reflect the level of fishing activity and prices. Dividends grew with the expansion in fishing activity, then fell in FY2014 and FY2015, reflecting weak fish prices, but rose from FY2016 through FY2018 as prices firmed. Other payments of primary incomes are interest payments on external debt and Compact rent payments to Kwajalein nonresident landowners living in the United States.

US grants are the major element of secondary incomes: The secondary income account provides a major source of revenue for the RMI. Budget grants include both the sizeable Compact grants and other transfers received from the ROC and US federal programs. At the start of the amended Compact, grants showed a significant upward trend, reflecting the increase in the absorptive capacity of the RMI to implement the grants rather than any increase in available funds. Since FY2009 the level of Compact grants has stabilized. The CMI receives relatively large transfers from US federal Pell grants. "Other" receipts include inward remittance flows to households, an important item but one for which few reliable data exist.

Secondary income outflows are minor, but migrant outflows of foreign workers have been growing: Remittance outflows are mainly household transfers and are estimated to be larger than inward remittances from Marshallese living in the United States. Included in outward transfers are payments not only from Marshallese families but also from the sizeable Chinese and other Asian communities living in the Marshall Islands.

US capital grants have dominated the capital account, but aid from multilateral donors will grow rapidly: The capital and finance accounts of the BoP are shown in table 4. The capital account includes Compact capital grants, which reflect the use of the infrastructure-sector grant. In the early part of the amended Compact, capacity constraints limited the use of this grant, but these issues were quickly resolved.

Table 4 Balance of payments, capital and finance accounts, FY2010–FY2018

(US$ millions)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Capital account balance	26.6	21.9	16.0	23.3	17.0	16.1	18.3	20.1	16.5
Capital inflows	26.6	23.2	17.0	23.3	17.0	16.1	18.3	20.1	16.5
National gov't, Compact capital grants	13.3	12.0	5.4	4.2	1.9	2.6	3.8	11.2	8.2
Other capital grants to government	13.3	11.2	11.6	19.1	15.1	13.4	14.5	8.8	8.2
Capital outflows	0.0	1.2	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing (curr + cap)	-2.1	23.7	15.2	11.6	23.3	47.9	50.7	36.1	33.0
Financial account balance	32.3	18.6	17.1	28.9	6.1	-3.8	-9.6	-11.8	19.9
Direct investment	37.8	5.8	4.6	6.9	4.6	4.0	5.3	6.5	7.2
Portfolio investment (increase in assets: -)	7.3	15.3	6.9	10.6	16.9	20.3	17.6	7.9	11.5
Assets	6.9	15.2	6.6	10.8	15.6	19.6	17.2	9.2	11.3
Local government, trust funds 1/	10.1	14.0	13.1	13.2	14.4	13.7	13.5	13.5	13.5
Social security	-3.3	1.2	-6.5	-2.4	1.1	5.9	3.7	-4.3	-2.3
Other investments	0.1	~	~	~	~	~	~	~	~
Liabilities	0.4	0.1	0.3	-0.1	1.3	0.7	0.4	-1.3	0.3
Other investment (increase in assets: -)	-12.9	-2.4	5.6	11.4	-15.4	-28.1	-32.5	-26.2	1.2
Assets (bank deposits)	-8.2	-0.1	9.8	9.6	-12.2	-22.9	-27.8	-20.3	6.5
Liabilities (public sector loans)	-4.7	-2.3	-4.2	1.7	-3.2	-5.2	-4.7	-5.9	-5.2
Errors and omissions	-30.1	-42.3	-32.4	-40.5	-29.4	-44.0	-41.1	-24.3	-52.9

2/ Coverage of nuclear-related trust funds is incomplete.

In FY2012 US concerns over procurement procedures limited implementation, and all new projects went on hold. Compact capital-grant receipts had virtually disappeared by FY2014, but in 2016 project-management issues were resolved. In FY2017 use of infrastructure funds had returned to normal levels, and it is likely to increase in subsequent years as the backlog of unused funds is programmed. "Other" capital grants, which include FAA grants to the Ports Authority for airport improvements, rose significantly in FY2013, reflecting the Majuro-airport-realignment project, and offset the decline in infrastructure-grant disbursements. Other grants are anticipated to grow strongly in the future with the large increase in aid from the World Bank and the ADB.

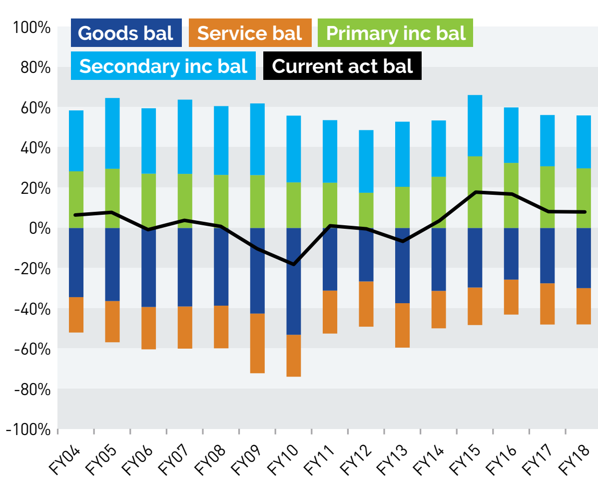
FDI, normally minor, rose with the reopening of the loining plant and investment in purse seiners: In regard to the financing account, direct investment flows have generally been small. However, from FY2007 through FY2010, direct investment increased because of the reconstruction of the fish-loining plant and investment in three purse seiners by PPF.

Portfolio investment is dominated by changes in nuclear reparation funds: (Note that increases in assets are shown as negative in the BoP, while increases in liabilities are positive.) The United States paid sizeable reparations and funds for relocation to the islanders of Bikini, Enewatok, Utrik and Rongelap atolls who were affected by the nuclear testing in the 1950s, and table 4 indicates the estimated sizeable drawdowns from these trust funds. Unfortunately, the lack of current audits results in our use of the most recent data to estimate these flows. The MISSA has held significant reserves for future pension payments, and there was a significant buildup in reserves through FY2013. However, the deterioration of the financial position of the fund in FY2014–FY2016 resulted in a significant drawdown of reserves to fund benefits. The outturn was positive in FY2017, reflecting strong market performance. Reforms were also enacted in the same year and have significantly improved the status of the fund. After receipt of subsidy from the RMI government, the need for further drawdowns from the investment corpus will be reduced at least in the medium term. This is an issue taken up in the financial chapter of the Review.

Other investments are normally dominated by a buildup in bank foreign assets: The buildup in commercial bank foreign assets has generally reflected deposit growth. In FY2012 and FY2013, with the Kwajalein-landowner rent payout, deposits and commercial bank foreign assets fell. In FY2018 the usual build-up in commercial deposits failed to materialize and the level of foreign assets fell by $6 million. Other investment liabilities reflect drawdowns and repayments on external debt. In FY2018 the result for "other investments" was thus a large change from the prior three years' build-up in assets of close to $30 million to a net use of funds of $1 million.

Overall trends in the BoP: The structure and current trends in the BoP are displayed in figure 16. Deficits in goods and services are matched by positive outcomes on the primary and secondary income accounts. In essence, the imports of goods and services are financed out of positive receipts from earnings of Marshallese workers at the Kwajalein US base, rent of the base, recent fishing-fee royalties, and current Compact and other aid transfers. The balance on current account averaged a positive 2.5 percent of GDP during the amended Compact, although the annual position has varied significantly. In FY2015 and FY2016, the significant reduction in fuel prices coupled with rising sovereign rents led to a favorable outcome on the current account. In the last two years, the improvements in the terms of trade have waned, but fishing

Figure 16
Balance of payments, current account: percent GDP



fees have remained strong and the current-account balance has remained positive.

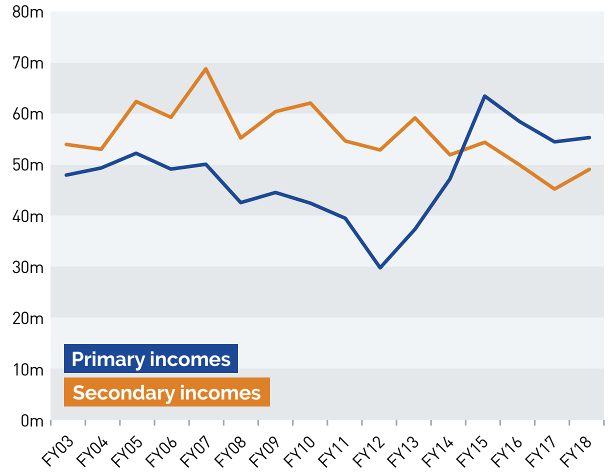
Errors and omissions in the BoP indicate significant measurement issues: Overall, errors and omissions (the difference between net lending and the financing account) have averaged −$40 million during the FY2004–FY2018 period, or 19 percent of goods and services. Since FY2010 the error has fallen and averaged 15 percent, but it remains high. Clearly, there is a consistent negative bias and error in the BoP of a significant amount reflecting the fact that a variety of flows are not known with precision.

B. Gross National Disposable Income

GNI and GNDI are 30 and 54 percent higher than GDP in FY2018: The availability of BoP estimates enables us to generate gross national income (GNI) and GNDI. In most countries, economic analysis tends to focus on GDP, which is usually the most appropriate reflection of the economic circumstances of the country under investigation. However, in the RMI the large inflows of primary and secondary incomes from the rest of the world indicate that analysis should also feature changes in GNI and GNDI. In the RMI, GNI and GNDI were 30 and 54 percent higher than GDP in FY2018, respectively. While analysis of GNI and GNDI might be placed in the section on GDP, it was thought more appropriate to put it in the section following the analysis of the BoP since the data to construct the additional series come from the BoP. In analyzing the results, it is useful to single out developments in constant-price changes in primary and secondary incomes, which are provided in figure 17. Both the primary and secondary incomes of the BoP have been deflated by a composite index of the CPI and GDP deflator. Figure 18 provides a description of the trends in GDP, GNI and GNDI from FY2004 through FY2018.

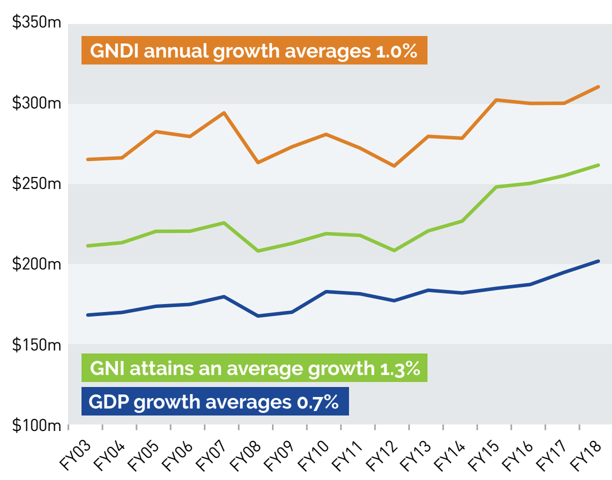
Real primary incomes fell in the initial years of the amended Compact but grew strongly in FY2012–FY2015 with the rapid increase in fishing fees: The main determinants of primary incomes are compensation of employees at the Kwajalein base, rent received by the

Figure 17
Primary and secondary incomes: constant prices 2015



Kwajalein landowners, fishing-fee royalties, earnings on portfolio investments, and interest and dividends paid on external debt and FDI. In FY2008 retrenchments were made at the base as the new fiber optic cable was installed; compensation of employees fell, although it has since regained ground. Land-rent receipts of the Kwajalein landowners have risen in line with the two-thirds partial inflation indexation of the amended Compact. However, fishing-fee income has grown very rapidly during the past five years. Dividends earnings on investments

Figure 18
GDP, GNI and GNDI, constant prices 2015



have been weak, following the world recession in FY2008. On the payments side, the increase in fishing output has been matched by growing dividend payments on FDI. The overall impact of these forces in constant prices has been that through FY2012, primary incomes (net) were falling, but after FY2012, with the rapid growth in fishing fees, real primary incomes (net) rose very significantly through FY2015. In the more recent period, FY2016–FY2018, fishing royalties reached a plateau and primary incomes declined.

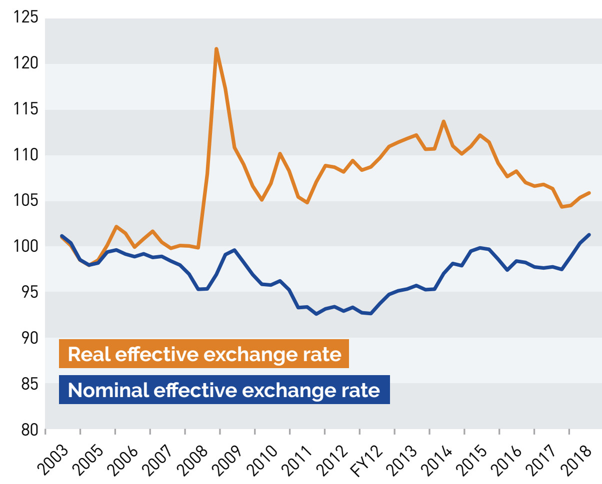
Real secondary incomes rose in the early stages of the amended Compact but have subsequently trended downward: In the case of secondary incomes, the series is dominated by Compact and other-country grants. At the start of the amended Compact, grants rose strongly through FY2006, but thereafter they have held steady in nominal terms at about $60 million per annum. Translated into constant prices, secondary incomes rose through FY2006 but subsequently trended downward.

With booming fishing royalties, growth in GNI has exceeded GDP, but the secular decline in real grants has resulted in lower growth in GNDI: During the amended Compact period, GDP trend growth averaged 1.0 percent. The impact of declining real primary incomes in the early stages and subsequent rapid rise after FY2012 resulted in real GNI achieving a trend growth of 1.3 percent—above the rate of growth of GDP. Given the deterioration in the level of secondary incomes after FY2007 and combining the various forces, GNDI trend growth averaged 0.7 percent. Looking forward, it is not expected that fishing royalties will rise rapidly; instead, they will stabilize at about current levels in real terms. However, secondary incomes are likely to continue their downward trend, given the partial indexation of the Compact sector grants. Thus, while GNI growth may converge to that of GDP, GNDI is likely to be less buoyant.

C. Nominal and Real Effective Exchange Rates

The RMI nominal effective exchange rate (NEER) is a trade-weighted index of the exchange rates of countries with which the RMI engages in trade in goods and services:

Figure 19
Nominal and real effective exchange rates, FY2004=100



The currency composition of the RMI's trading relations has been estimated through analyzing the origin of imports and estimating exports of both goods and services. Given the RMI's historical relationship with the United States, the US dollar dominates and accounts for 63 percent of international trade. Considering that the RMI uses the dollar as its currency of exchange, the NEER is essentially a trade-weighted index of the US dollar against the RMI's trading partners. Figure 19 indicates that the NEER depreciated during the first nine years of the amended Compact, reflecting the depreciation of the dollar, gained strength as the dollar strengthened in subsequent years, and weakened at the start of 2016. The recent strengthening of the US currency led to an appreciation of the dollar in FY2018.

The REER is a measure similar to the NEER, but currency movements are adjusted for changes in the CPI of the respective countries: It is thus a proxy for gains or losses of international competitiveness. From the start of the amended Compact through FY2007, the REER went largely unchanged, but after that point, with the significant increase in inflation in the RMI due to rising fuel and food prices, the REER spiked in FY2008. The REER depreciated in FY2009, but it did not adjust downward to the prior level. After FY2009 the REER displayed a rising trend, reflecting two main forces: the appreciation of the dollar and a higher rate of inflation in the RMI compared with the RMI's trading partners. During 2016 the dollar started to depreciate and, coupled with the lower and negative inflation in the RMI, the real exchange rate depreciated.

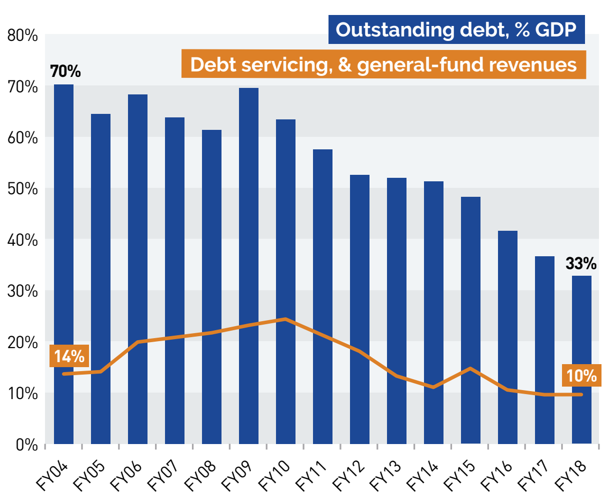
D. External Debt and Management

EXTERNAL-DEBT PERFORMANCE

The level of external debt has fallen significantly, but the RMI remains designated as being at risk of high debt stress: Figure 20 shows the substantial size of the RMI's external debt and the burden of the debt servicing from FY2004 to FY2018. In FY2004 the level of outstanding debt was $94 million (70 percent of GDP). External debt recorded a level of $73 million at the end of FY2018, but, as a percentage of GDP, it has declined significantly to 33 percent. While most of the debt is on concessional terms, the level of debt remains above the 30 percent threshold that qualifies the RMI as being at high risk from "debt stress" according to the IMF's debt-sustainability analysis (DSA).

While debt levels have fallen, the RMI has gone through periods of high debt stress, although these have now abated: While the profile of RMI debt as a percentage of GDP has improved significantly, the external-debt-service picture has undergone a different profile. While much debt is on concessional terms, there was a substantial rise in debt service on the government's portion during early stages of the amended Compact. As grace periods of prior loans expired, debt service increased from $4.3 to $8.7 million in FY2010. While debt service as a percentage of general-fund revenues rose rapidly from 14 percent at the start of the amended Compact to over 24 percent in FY2010, it has now fallen back to less than 10 percent, placing it below the IMF threshold of 18 percent. While the value of debt service is now only slightly below its peak, general-fund revenues have improved markedly, easing the burden of repayment, and the issue of debt stress has abated.

Figure 20
RMI external debt (percent GDP) and debt service (percent general-fund revenues)



GOVERNMENT AND SOE DEBT

ADB debt: During Compact I, the government developed a substantial portfolio of loans from the ADB (see table 5). The RMI began borrowing from the ADB in 1993 with the funding of the Fisheries Development Loan, which focused on fisheries development in Ebeye. Subsequent loans have included resources for water-supply, social-sector, and transport projects, including reform-program loans. In total, the ADB has approved $87.1 million worth of loans since the RMI joined in 1991. After debt repayment and lack of full disbursement of some loans, outstanding ADB debt at the end of FY2018 was $51.4 million. All but $4 million of this outstanding amount is provided on highly concessional terms from the Asian Development Fund (ADF) resources of the ADB. These resources provide grace periods of 8 to 10 years and full repayment of principal over 40 years (including grace periods) for older loans and shorter repayment periods for more recent loans. No interest is applied to the principal of these loans, although a "service charge" of 1 to 1.5 percent is applied to the outstanding principal. New program loans, such as the Public Sector Program (PSP), now have a term of 24 years. The concessional nature of the lending means the ADF loans have a significant grant component when valued on a discounted cash flow basis.

Rural Utilities Service (RUS) debt: Other major external-debt commitments include government-guaranteed debt to the SOE sector and liabilities owed to the RUS, formerly known as the Rural Electrification Administration, for loans to the NTA and the MEC. In 1989 the RMI guaranteed an $18.8 million loan to the NTA, which was extended by another $4 million in 1993. In 2009 the NTA extended the RUS facility by a further $14.5 million to finance the fiber optic link from Kwajalein to Majuro, although the extension of the loan was not guaranteed by the RMI government. In 1997 the MEC secured an RUS loan for $12.5 million to finance the new power plant on Majuro. In all cases of default by the SOEs, with the exception of the recent RUS extension, the RMI must meet debt-service requirements.

Financing of the fiber optic cable: It was recognized in FY2009 that the financing of the new fiber optic cable through extension of the existing RUS facility would place the NTA in a negative income position. However, it was felt that benefits to the RMI economy and communities from being part of the internet were worth the financial commitment. In a memorandum of understanding, the NTA and the government agreed that the government would support the NTA with a regular subsidy equivalent to the debt-service commitment of about $1.25 million. However, irregular payment and nonpayment of the subsidy have on occasion forced the NTA into default until the government made good on the back payments owed.

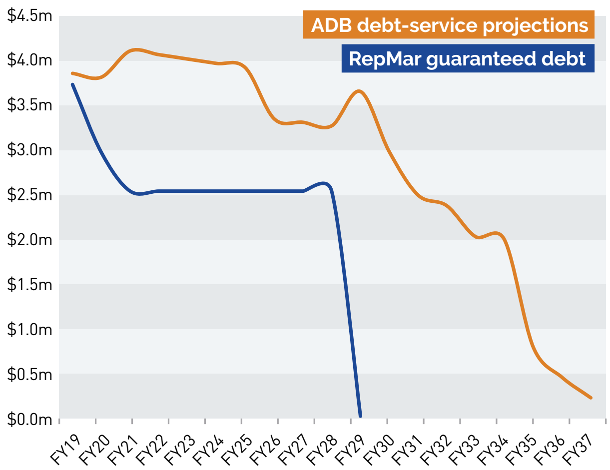
DEBT PROJECTIONS

SOE debt projections: Figure 21 indicates the projected trend in debt service for government debt owed to the ADB and government-guaranteed debt incurred by the SOE sector. External debt of the SOEs comes at higher interest rates and on shorter terms and thus incurs a proportionately higher service commitment. Debt service of the NTA and MEC is projected in FY2018 to be $2.6 and $1.2 million, respectively. SOE debt service is projected to fall to $2.6 million in FY2021, once the MEC debt is repaid, leaving the NTA as the sole remaining SOE with external-debt-service obligations until FY2030, when the RUS loan is fully paid down.

Table 5 External debt, original value, and outstanding principal by loan as of September 30, FY2018

Loan	Lender	Number	Year	Original debt, (US$ millions)	Estimated outstanding principal September 2018, (US$ millions)
Ebeye Fisheries Loan	ADB	1102-MAR (SF)	1992	3.5	1.8
Emergency Rehabilitation Loan (Typhoon Gay)	ADB	1218 MAR (SF)	1993	0.5	0.3
Basic Education Project Loan	ADB	1249 MAR (SF)	1993	8.4	4.8
Majuro Water Supply Project Loan No. 1	ADB	1250 MAR (SF)	1993	0.8	0.4
Majuro Water Supply Project Loan No. 2	ADB	1389-RMI (SF)	1995	8.4	5.6
Health and Population Project Loan	ADB	1316-RMI (SF)	1995	5.9	3.3
Public Sector Reform Program	ADB	1513-RMI (SF)	1997	12.0	8.4
Ebeye Health and Infrastructure	ADB	1694-RMI (SF)	1999	9.3	4.8
Skills Training and Vocational Education Project Loan	ADB	1791-RMI (SF)	2001	7.6	3.0
Fiscal and Financial Management Program Loan	ADB	1829-RMI (SF)	2001	8.0	3.7
Outer-Islands Transport and Infrastructure Loan	ADB	1948-RMI (SF)	2003	7.9	0.3
Public Sector Program	ADB	2659-RMI (SF)	2010	10.0	10.0
Public Sector Program	ADB	2950-RMI (SF)	2013	4.9	4.9
Marshalls Energy Company - new power plant loan	RUS		1997	12.5	1.4
NTA Loan	RUS		1989, 1993, 2009	41.3	19.7
Total				**140.9**	**72.5**

Figure 21
RMI debt- servicing projections, government and SOEs, FY2019–FY2037



ADB debt projections: For debt to the ADB, the government will be required to set aside on average $3.7 million, maxing out at $4.1 million in FY2021, from the general fund through FY2030, when debt service begins to drop off as loans are repaid. Currently, this represents 4.4 percent of the $74 million of general-fund revenues in FY2018. In earlier years, nearly all of the RMI debt was in grace period and debt-service obligations were not significant, but in recent years principal repayments for many of the loans have fallen due. In FY2019 the government will make the first repayment of the PSP loan, but in FY2020 it will have fully liquidated the Fiscal and Financial Management Program loan of 2001. In FY2021 the government will commence repayments under the Fiscal Reform and Debt Management component, the second tranche of the PSP.

GRANT-ONLY STATUS

RMI accorded "grant only" status: As a result of the IMF/World Bank's DSA indicting the nation as being at high risk of debt stress, the RMI has now been designated as grant only, implying it is no longer eligible for loan financing from multilateral donors. This status is granted on condition that the RMI does not incur debt from third parties on a nonconcessional basis. Given the experience of the RMI in fulfilling its debt obligations, this might seem a desirable outcome. However, the restriction implies limited capacity to borrow for larger infrastructure projects, which could place limitations on development. The recent rapid rise in resource availability from both the World Bank and the ADB (approximating $35-$40 million a year, or close to 16 percent of GDP) suggests this may well not be an issue if the RMI is able to channel the funds into priorities of its choosing.

DEBT MANAGEMENT

The RMI experienced periods of debt delinquency during the global financial crisis: In FY2006, the RMI government experienced its first problems in servicing ADB debt and defaulted on several loans. In FY2007 it remained in arrears as service obligations rose to $2.2 million. By FY2008 the government placed ADB debt service higher on its payment-priority schedule. It made good on past delinquencies and is currently up to date with payments. The failure to pay regular subsidies to the NTA for debt service on the fiber optic commitment was a weak spot. The debt-service crisis brought home the impact of a poorly managed external-debt strategy.

Need for debt strategy: Given the current grant-only status, the need for a well-articulated debt-management strategy to encourage the RMI to maintain debt at prudent levels may not seem necessary. However, recent applications to IRENA for loan funding and a stream of other projects totaling close to $80 million may suggest otherwise. The IRENA project was found to be above the World Bank concessional-loan threshold and would have placed the RMI at risk of losing the grant-only status. It is thus suggested that the RMI might still wish to consider implementation of a debt-management strategy to enable it to determine the type of projects for which external-loan finance is appropriate and to identify cases for which there is potential for projects to cover service costs. A debt-management strategy was developed and adopted by the cabinet several years ago. As the nation currently implements a series of PFM reforms, the timing might be appropriate to reconsider the former bill.

Table 6 Marshall Islands: International investment position, FY2010–FY2018

(US$ millions)	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Total stocks, net	244.4	224.9	235.8	235.4	247.9	253.9	277.2	308.7	309.7
Direct investment, net	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Portfolio investment, net	276.5	254.4	270.8	281.7	278.5	256.0	245.9	251.5	253.6
Assets	279.3	257.3	274.0	284.7	282.9	261.0	251.3	255.7	257.9
Nuclear Claims Tribunal	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	~
Intergenerational Trust Fund	~	~	~	~	~	~	~	~	~
Local government, trust funds 1/	227.0	206.3	216.4	224.8	224.0	208.1	202.1	202.1	202.1
Social security portfolio	52.2	51.0	57.6	60.0	58.9	52.9	49.3	53.6	55.9
NTA portfolio	~	~	~	~	~	~	~	~	~
Liabilities	2.8	2.9	3.2	3.1	4.4	5.1	5.4	4.1	4.4
Equity: capital and retained earnings of foreign-owned banks	2.8	2.9	3.2	3.1	4.4	5.1	5.4	4.1	4.4
Debt: medium-term notes	~	~	~	~	~	~	~	~	~
Other investment, net	-32.1	-29.5	-35.0	-46.2	-30.6	-2.1	31.2	57.2	56.1
Assets	71.8	71.9	62.1	52.5	64.7	87.6	115.4	135.7	129.2
Deposits, commercial banks 2/	71.8	71.9	62.1	52.5	64.7	87.6	115.4	135.7	129.2
Liabilities, loans	103.9	101.4	97.1	98.7	95.3	89.6	84.1	78.5	73.1
Government	57.4	65.2	62.8	65.4	62.9	60.1	57.2	54.7	52.0
Public entities	46.5	36.3	34.3	33.3	32.4	29.5	26.9	23.8	21.1

1/ Coverage of local government trust funds is incomplete.

2/ At banks abroad.

E. International Investment Position

The RMI nuclear trust funds form the major element of the international investment position (IIP), but lack of audits makes estimation difficult: The RMI IIP is presented in table 6. The data show stock positions at the end of each year corresponding to the financial account of the BoP. While no record of FDI is available, the table provides an important indication of the RMI's portfolio and other investments. The major element of portfolio investment is the RMI's nuclear-related trust funds held by local governments, which have not been audited for some years, although efforts to improve the information are ongoing. The magnitude of the funds and their impact on the economy are substantial. The portfolio lost value with the financial crisis in FY2008 and FY2009 but saw improvement in FY2013 (estimates for recent years are based on the most recent audits).

SS investments stabilize after the 2017 reforms, with commercial bank offshore deposits being the other major quantifiable IIP item: The Social Security Administration is the other major holder of portfolio investments and has experienced similar market forces to the nuclear funds, but its reserve fund declined in FY2013–FY2016, reflecting the underlying deterioration in the financial position of the system. In FY2017 and FY2018, SS grew favorably, reflecting strong market performance. In 2017 reforms were enacted to place the system on a more sustainable basis, but transfers from government are still required to maintain the level of investments. This issue is taken up in greater detail in the policy chapter of this review. Under the "other investment" category, the commercial banks hold significant foreign assets, representing that portion of bank deposits that are not loaned out in the RMI. These amounted to $129 million at the end of FY2018. Finally, the external debt of the government and public corporations represents the nation's major external liabilities.

3. Fiscal Developments

The RMI and US governments' adoption of the amended Compact, which became effective in FY2004, initiated a new fiscal framework for the RMI. The new structure entailed a series of sector grants earmarked for education, health, private sector development, capacity building, infrastructure and the environment.

- The innovative element of the amended Compact was the introduction of a trust fund, which was designed to provide a yield sufficient to replace the annual grants after 20 years.
- The RMI has a mixed record of timeliness in the preparation and publication of the annual single audits by June 30 of the subsequent year. The FY2011 audit was delayed until early 2013, and for the FY2013 audit the government was granted a three-month extension. Since FY2015, with additional accountants recruited, the audits have been completed on time.
- The RMI has achieved significant fiscal surplus during the last four fiscal periods, averaging 3.4 percent of GDP. Revenues have grown strongly, reflecting buoyant growth in taxes but also large increases in nontax revenue: fishing fees and receipts from the corporate and ship registry.
- The very significant improvement in the fiscal position has unfortunately been accompanied by large matching increases in expansionary budgets during the last four fiscal periods. While the attainment of significant surpluses is to be congratulated, the lack of discipline in controlling expenditures is of serious concern.
- The tax regime in the RMI is based on a tax system inherited from—and largely unaltered since—Trust Territory days. The major sources of tax revenues include a tax on wages, the GRT and customs duties. Overall, the RMI tax regime is in need of reform, displays a lack of buoyancy and fails to provide a growing source of revenues over time.

3. Fiscal Developments

A. The Fiscal Framework

Amended Compact basics: The RMI and US governments' adoption of the amended Compact, which became effective in FY2004, initiated a new fiscal framework for the RMI. The new structure entailed a series of sector grants earmarked for education, health, private sector development, capacity building, infrastructure and the environment. In addition to the sector grants, the amended Compact provides annual grants for special needs of the community at Ebeye ($3.1 million, rising to $5.1 million in FY2014), special needs of the community at Ebeye with emphasis on the Kwajalein landowners ($1.9 million), Kwajalein landowners ($15 million, rising to $18 million in FY2014) and audit ($0.5 million).

CTF and grants: The innovative element of the amended Compact was the introduction of a trust fund, which was designed to provide a yield sufficient to replace the annual grants after 20 years. Table 7 indicates the aggregate structure of the annual Compact grants and the contribution to the CTF. Each year, over a 20-year period, the United States will contribute $57.7 million to the RMI, partially adjusted for inflation. The inflation-adjustment factor remains as in the original Compact. The annual sector grants start at $30 million in FY2004 but are to be annually reduced by $0.5 million. The difference between the total contribution and the annual grant levels will be deposited in the CTF to accumulate over the 20-year Compact period. The United States agreed to contribute a further $5 million to the RMI in FY2014, $2 million of which was allocated to the Ebeye special community grants, the remaining $3 million to be allocated to the Kwajalein landowners.

Table 7 US annual Compact grants and contributions to the trust fund (US$ millions)

	Annual sector grants	Ebeye special community needs	Ebeye community landowners	Ebeye environ-mental impact	Audit	Kwajalein impact (landowners)	Trust fund contribution	Total contributon
FY04	30.0	3.1	1.9	0.2	0.5	15.0	7.0	57.7
FY05	29.5	3.1	1.9	0.2	0.5	15.0	7.5	57.7
FY06	29.0	3.1	1.9	0.2	0.5	15.0	8.0	57.7
FY07	28.5	3.1	1.9	0.2	0.5	15.0	8.5	57.7
FY08	28.0	3.1	1.9	0.2	0.5	15.0	9.0	57.7
FY09	27.5	3.1	1.9	0.2	0.5	15.0	9.5	57.7
FY10	27.0	3.1	1.9	0.2	0.5	15.0	10.0	57.7
FY11	26.5	3.1	1.9	0.2	0.5	15.0	10.5	57.7
FY12	26.0	3.1	1.9	0.2	0.5	15.0	11.0	57.7
FY13	25.5	3.1	1.9	0.2	0.5	15.0	11.5	57.7
FY14	25.0	5.1	1.9	0.2	0.5	18.0	12.0	62.7
FY15	24.5	5.1	1.9	0.2	0.5	18.0	12.5	62.7
FY16	24.0	5.1	1.9	0.2	0.5	18.0	13.0	62.7
FY17	23.5	5.1	1.9	0.2	0.5	18.0	13.5	62.7
FY18	23.0	5.1	1.9	0.2	0.5	18.0	14.0	62.7
FY19	22.5	5.1	1.9	0.2	0.5	18.0	14.5	62.7
FY20	22.0	5.1	1.9	0.2	0.5	18.0	15.0	62.7
FY21	21.5	5.1	1.9	0.2	0.5	18.0	15.5	62.7
FY22	21.0	5.1	1.9	0.2	0.5	18.0	16.0	62.7
FY23	20.5	5.1	1.9	0.2	0.5	18.0	16.5	62.7

The decrement: In comparison with the original Compact, the new arrangement avoids the need for large fiscal adjustments every five years. However, to establish the viability of the CTF, the United States instigated the annual decrement. While avoiding large shocks to the system, the decrement will still require yearly adjustment. Coupled with the lack of full inflation adjustment, the annual reduction in real resources—estimated to be approximately 2 percent—will require active fiscal-policy modifications to compensate for the shortfall.

JEMFAC: The annual budget allocations are awarded through the JEMFAC. The United States has a controlling influence, with three members, and the RMI has two members. Each year, the RMI presents its annual sector-grant submissions to the United States in advance of the JEMFAC annual meeting, convened in late August to make the annual budget allocations before the new fiscal year starts on October 1. Unlike the FSM, where JEMCO budget resolutions can be passed by the United States on a three-to-two basis, JEMFAC resolutions must be agreed on by consensus. Of course, since the United States has effective veto rights over budget allocations, it maintains a strong influence on outcomes. Further, nonbudgetary JEMFAC resolutions are not subject to consensus, and the United States has outright control.

Infrastructure requirements: A special condition agreed upon by both parties is that the RMI will devote between 30 and 50 percent of the total Compact sector grant specifically to infrastructure. Of the infrastructure grant, 5 percent must be set aside for infrastructure maintenance, and the RMI must contribute an additional 5 percent out of local revenues. In general, implementing the sector-grant approach of the amended Compact did not impose on the RMI any effective fiscal constraint or need for restructuring. At the outset, there were sufficient general-fund revenues to maintain operations without cutting back expenditures in non-Compact sectors. From FY2004 to FY2018, the use of the minor sector grants for private sector development, public sector capacity building and the environment represented less than 1 percent of Compact awards and was minimal.

Federal programs and the SEG: Access to federal programs continues, with the exception of certain education programs, which were "cashed out" and have been replaced through the SEG. The amended Compact specified an initial SEG award of $6.1 million, and the award is eligible for annual inflation adjustment consistent with the rule applied to sector grants. However, since this award is subject to annual appropriations, actual awards vary. The trend in the SEG, as recorded in the annual audits, has been downward and averaged $5.2 million during the last three years. Finally, implementing the amended Compact entailed a whole new accountability regime, which is specified in the fiscal-procedures agreement (FPA). Taken as a whole, the fiscal arrangements of the amended Compact have had an important impact on the conduct of fiscal policy and management in the RMI.

Relations with the ROC: In addition to the special relationship the RMI enjoys with the United States, the RMI has also developed strong ties with the ROC. The ROC initially contributed $10 million annually to the RMI government, of which $4 million was transferred to the general fund and the remaining $6 million was available for special projects to be agreed upon between the parties. As fiscal pressures have mounted, more of the project money has been used for general activities, and, in effect, the project contribution largely augments general-fund revenues. Of special significance is the additional support provided by the ROC to the CTF. By way of a memorandum of understanding, the ROC has agreed to transfer $50 million to the RMI during the period of the amended Compact; $40 million of this will accumulate in the A account and $10 million in the D account. Funds in the A account may not be touched during the amended Compact period, while the RMI has the right to utilize the yield earned on the resources in the D fund once they have reached $10 million.

Fund accounting: Fiscal policy in the RMI is conducted under the constitutional requirement of a balanced budget. This, of course, does not guarantee that the final outcome will also be balanced: either revenue may fall short, or expenditures may exceed budget estimates. The execution of the budget operations is performed through a series of separate funds, the most important of which is the general fund. Expenditures from this fund are largely unrestricted, but there is limited flexibility or authority to use monies from the other funds. Under Compact I, a major part of the external assistance provided revenue to the general fund and thus was unrestricted. Under the amended-Compact-grant and sector-grant approach, however, all such receipts are earmarked for specific purposes and must be liquidated if they remain unused at the end of the financial year. This requirement effectively inhibits deficit spending under the sector grants. Fiscal policy in the macroeconomic sense is thus executed only through the general fund. The structure of the standard Government Finance Statistics (GFS), which aggregate across funds and focus on “above the line” revenues and expenditures and “below the line” financing, does not always highlight some of the additional constraints faced by policy makers.

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

Audit performance: The RMI has a mixed record of timeliness in the preparation and publication of the annual single audits by June 30 of the subsequent year. The FY2011 audit was delayed until early 2013, the FY2012 audit was one month late, and for the FY2013 audit the government was granted a three-month extension. In FY2014, although the RMI was given a three-month extension, the final audit was not completed until the end of February 2016, eight months late. For FY2015 capacity limitations persisted, and the final audit was not produced until November. In the last three years, FY2016 to FY2018, with additional accountants recruited and support from the ADB, the audit has been completed on time.

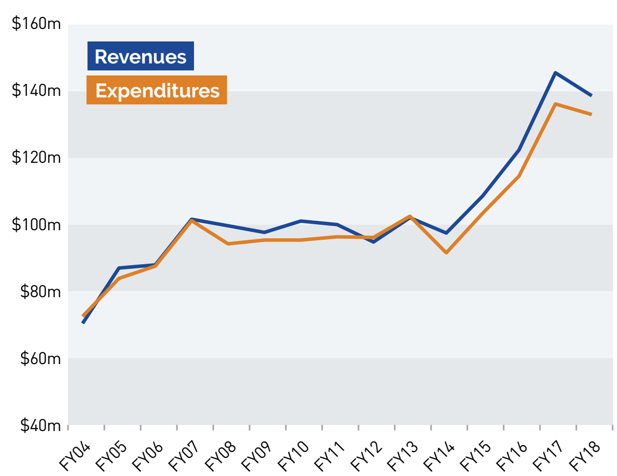
In this chapter, discussion will focus on fiscal developments during the FY2004–FY2018 period. Analysis of the emerging fiscal situation and the fiscal outlook will be undertaken in chapters 4 and 9, “Policy Sector Management and Adjustment” and “Long-Term Economic Outlook.” The following discussion is based on a standard GFS format.

B. Recent Fiscal Performance

FISCAL PERFORMANCE

The early years of fiscal expansion in the new Compact, FY2004–FY2007: Fiscal developments during the amended Compact may be divided into three periods: an expansionary period during the early years of implementation, from FY2004 to FY2007; a stagnant period ushered in by the financial crisis of FY2008–FY2009 and extending through FY2014; and an expansionary fiscal period reflecting booming fishing revenues during the last four fiscal periods, FY2015 through FY2018. Figure 22 represents recent trends in the fiscal position. It indicates expenditures grew strongly in the first three years of the amended Compact, after the repressed years at the end of Compact I, with the availability of higher levels of funding. Initial capacity-utilization issues with the infrastructure grant in the first two years of the amended Compact were overcome by FY2006, allowing

Figure 22
RMI consolidated revenues and expenditures, FY2004–FY2018



further expansion. While a deficit of 1.6 percent of GDP was recorded in the first year of the amended Compact, surpluses were attained from FY2005 to FY2007 (adjusting for the need to contribute $33 million to the CTF in FY2005).

Fiscal consolidation, FY2008–FY2014: By FY2008, the period of fiscal expansion driven by the release of and capacity to utilize new funding had run its course, and a long period of fiscal restraint through FY2014 was required. Revenue effort was weak throughout this period, falling by 0.6 percent per annum. Tax effort was stagnant over the seven-year period despite growth in nominal GDP of 2.6 percent per annum, reflecting a weak tax regime. The GRT and customs duty declined while wage-tax growth was modest at 0.3 percent. Overall tax effort would have been negative if not for increased earnings from the ship and corporate registry. Current grants stagnated during the period, reflecting the fact that the partial indexation of the Compact sector grants offset the annual decrement. Capital grants, on the other hand, declined from the peak attained in FY2007, largely disappearing by FY2014 as the Compact infrastructure grant was placed on hold and the FAA airport project was finalized. The compensating factor during the period was the implementation of the VDS in FY2010, which initiated a rapid rise in revenue growth.

Expenditures grow faster than revenues, but fiscal balance maintained, FY2007–FY2014: On the expenditure side of the equation, current expense grew by 0.7 percent, a rate in excess of revenue growth, suggesting a tight fiscal position. Expense on payroll grew by 1.7 percent, while outlays on goods and services, payment of subsidies and transfers to government agencies remained largely unchanged, albeit with some volatility. Expenditures on fixed assets largely mirrored the pattern of capital grants, reflecting the policy to fund capital expenditures from aid. The overall outcome of the fiscal position was a pattern of small fiscal surpluses averaging 1.8 percent of GDP.

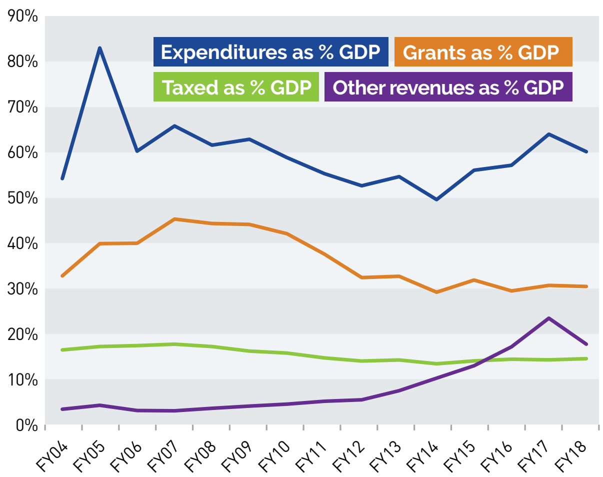
Rapid revenue growth and fiscal expansion, FY2015–FY2018: During the last three years, FY2015 through FY2018, the fiscal situation entered a new era after a period of stagnant revenues; the outlook shifted into high gear. Overall revenue growth expanded by 9 percent per annum, with all categories showing buoyancy. Tax revenues grew by 7 percent per annum with all the major taxes—wages tax, GRT and customs duties—showing solid performance. Revenues from the TCMI also grew at a rate consistent with prior performance. While current grants remained largely flat, capital grants improved, reflecting the lifting of the moratorium and full utilization of the infrastructure grant. The most dominant force was growth in fishing-fee royalties, which grew from $12 to $29 million during this period, with an exceptional year in FY2017 as the government drew down prior fishing fees that had accumulated at the MIMRA.

Expenditures expand rapidly, matching the available revenue growth, FY2014–FY2018: While the new buoyancy in revenues might have resulted in a period of consolidation and an opportunity to save the gains for the post–amended Compact period, expenditure growth matched that of revenues. During the four years, payroll expense grew by 4.6 percent above the historical average of 1.7 percent of the previous seven years. However, increases in payroll were modest compared with other areas of expense. Use of goods and services grew by 9.3 percent per annum, and subsidies by a massive 22 percent. Grants to government agencies and "other" expense also grew strongly by 18 and 12 percent, respectively. Fixed-asset outlays growth was more modest and matched that of capital-grant receipts. Despite the strong growth in expenditures and expansionary fiscal policy, the RMI managed to achieve an average surplus of 3.4 percent of GDP.

THE FISCAL STRUCTURE

Grants: Figure 23 provides a summary of the structure of the major components of the fiscal account. Grants stood at 33 percent of GDP in FY2004, revealing weak absorptive capacity and an inability to fully utilize the resources available under the amended Compact. Absorptive-capacity limitations were slowly overcome during the next few years. By FY2007 capacity utilization stood at 108 percent, indicating the use of carryover funds, as prior unspent resources were employed. As seen in figure 23, grants as a percentage of GDP rose to 45 percent in FY2007 but have slowly declined since that time, falling to 30 percent in FY2018.

Figure 23
Fiscal structure: taxes, grants, expenditures: percent GDP FY2004–FY2018



A similar trend is observed in grants as a percentage of total revenues—rising to a high in FY2007 and then falling during the remainder of the amended Compact. With an increasing level of nominal GDP and a stagnant level of Compact transfers after decrement and lack of full indexation, the declining trend can be anticipated to continue. Receipt of grants from other governments (mainly the ROC) and federal programs has fluctuated during the amended Compact but displays no discernable trend.

Tax revenues as a percentage of GDP grew in the early part of the amended Compact, reaching a peak in FY2007, but gradually declined through FY2014. Since that time, the downward trend has halted with little change in the tax-to-GDP ratio since that time. Trends in tax effort during the amended Compact reflect the outmoded tax regime and lack of tax buoyancy in the RMI. While tax effort is above that of the FSM, it is below that of the majority of other Pacific Island economies and beneath the rate prevailing in the United States. The notable change in the fiscal structure has been the rapid rise in other revenues, largely fishing-license fees and revenues from the MITC (ship registry and offshore corporate registration), which have risen from less than 2 percent of GDP at the start of the amended Compact to 19 percent at the current time.

Expenditures: Public expenditure, including outlays on nonfinancial assets, has followed the pattern of the various components of revenues, rising in the early part of the amended Compact through FY2007 as grant levels rose, declining through FY2014 as revenues stagnated and rising strongly in the last four years with the significant increase in fishing-fee income.

REVENUES

Wages tax: The tax regime in the RMI is based on a tax system inherited from, and largely unaltered since, Trust Territory days. The major source of tax revenue is a tax on wages, accounting for $15.1 million, or 47 percent, of a total tax yield of $32.1 million in FY2018. The contraction in military presence on Kwajalein in FY2008 and a reduction in Marshallese employees were expected to erode the tax base, and a $1.6 million decline was projected. However, nominal income tax receipts have largely held their level during the amended Compact; in effect, diminishing receipts from Kwajalein have been compensated by increases in general economic activity. Wage earners pay 8 percent of incomes up to a threshold of $10,400 and 12 percent above that. Those earning less than $5,200 have a tax-free threshold of $1,560. Estimates of the wage-tax buoyancy indicate a ratio of 0.86 to the tax base of compensation of employees. That is, for every additional percentage-point increase in wages, taxes only rise by 0.86 percent. This outcome is surprising given the inherent bias in the wage-tax structure that should generate proportionately more yield as wage earners move up the scale.

The GRT is levied at 3 percent of business turnover and is intended as a proxy income tax, although the incidence is comparable to that of a sales tax. The tax suffers from the well-known cascading effect, such that each sale from one business to another multiplies the tax yield and distorts resource allocation. Fish and fish products have been exempted from the GRT to enable the fishing sector to remain competitive in international markets. The estimate of the GRT buoyancy, the ratio of GRT collections to value added in industries generating GRT, is 0.85, close to that of the wages tax. As in the case of the wages taxes, one would expect a ratio of close to unity. This suggests underperformance in collections.

Customs duties provide the second most significant category for tax yield. They displayed strong growth through FY2007, as the economy expanded at the start of the amended Compact, but performed poorly through FY2014, reflecting the weak economy and impact of special exemptions and reductions in taxes on basic items. Since FY2014, as economic performance improved, import duties have also shown growth. In FY2004 the general rate of import duties was 8 percent, which has remained unchanged, although food items attract a lower rate and there are wide ranges of exemptions for different categories of importers. In FY2005 new, higher rates were imposed on "sin" goods, with the additional revenues earmarked for the CMI. In 2008, in a response to the high inflation in fuel and food prices, the government granted an import-duty exemption to the MEC for its imported fuel for commercial resale largely for re-export and to imports of basic food staples, such as rice and flour. The MEC was already eligible for duty-free import of fuel for power generation. Estimates of import-tax buoyancy, the ratio of customs-duty collections to imports f.o.b. in the BoP, indicate a ratio of −0.05; that is, as imports have grown, tax collections have fallen. The trend reveals that import taxes have provided an extremely poor source of revenue to the government.

Tax holidays continue to be granted by the cabinet in special cases, including exemptions on the GRT for existing fishing operations and electricity sales. To spur growth in exports and foreign exchange earnings, nations generally try to avoid taxing export-oriented business activities. This principle has not been adopted in the RMI, and several exporters, including the MEC, still pay GRT on their export revenues.

Nontax revenues: Fishing fees, the most buoyant form of nontax revenue, raised an average of $1.3 million during the FY2004–FY2009 period but were a volatile source, depending on the location of the fishing stock. Since FY2010, with the implementation of the VDS under the PNA, fishing fees have stabilized and been very buoyant, with the government receiving $29.4 million in FY2018. Levies charged on the RMI ship registry provide the remaining significant source of tax revenue. In FY2004 these levies generated $1 million in revenue for the RMI. Recent fee changes negotiated with the responsible enterprise, International Registries, have enabled growth from this source, which yielded $7.3 million in FY2018. The basis of estimation determined by International Registries lacks transparency, and the RMI would be well placed to conduct an independent investigation of the ship- and corporate-registration market and estimation of revenue potential from the business. This is discussed further in chapter 7. In addition to fishing fees, nontax revenues include a variety of smaller items, such as earnings on investments, administrative fees and incidental sales.

EXPENDITURES

Payroll: Outlays on payroll and goods and services are displayed in figure 24. Payroll costs grew rapidly at the start of the amended Compact, moderated in the fiscal-consolidation period, and accelerated in the last two years. At the start of the amended Compact, the improved financial conditions and the removal of the fiscal discipline necessary at the end of Compact I enabled a surge in payroll. From FY2003 to FY2006, payroll increased by 12.3 percent per annum. After FY2006, as expenditures hit their ceilings, only modest growth in payroll was possible, averaging 1.6 percent per annum between FY2006 and FY2016.[1] With the large increase in resources in recent budgets, payroll has grown rapidly in the last two years by an average 6.6 percent.

Goods and services: The trend in outlays on goods and services has been more erratic, expansionary, and strongly associated with the fiscal envelope. Outlays expanded during the initial years of the amended Compact once capacity limitations to the new regime were resolved, were held under close control during the period of fiscal consolidation in the mid-2000s, and expanded between FY2010 and FY2013 as the fiscal situation eased. In the last three years, use of goods and services grew strongly, reflecting the large increase in resource availability. While maintaining payroll but cutting other costs may keep expenditures within budget

1 In FY2007 the creation of the MISC, whose function was previously executed through the Ministry of Transport and Communications, led to the transfer of wage and other costs to the MISC, which is now supported by subsidy.

Figure 24
Expenditures on payroll and goods and services

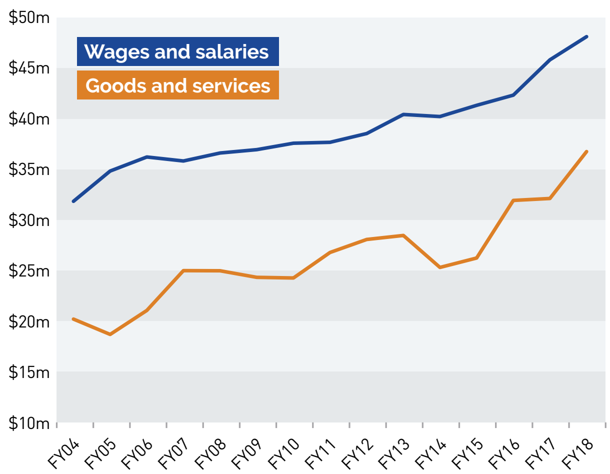
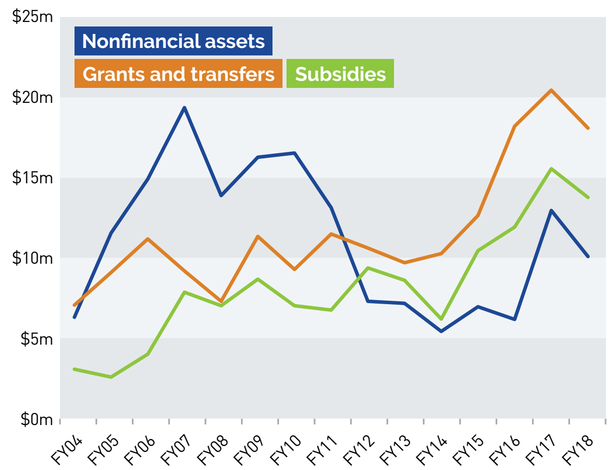


Figure 25
Subsidies, grants and nonfinancial assets



during periods of fiscal pressure, it may not be an efficient response if it undermines the ability to maintain proper levels of service because of inadequate supplies of goods and services.

Subsidies and transfers: The level of current subsidy to the public-enterprise sector has increased significantly during the amended Compact (see figure 25). The level of subsidy averaged $3.2 million from FY2004 to FY2006 and averaged $7.7 million between FY2007 and FY2014. During the last four years, there has been a marked increase in subsidies, which average $12.9 million and attained a record $15.5 million in FY2017. The level of subsidy represents a substantial and increasing drain on the RMI government's uncommitted resources. The issue of SOE policy is taken up in further detail in chapter 5. Grants and transfers to local government, extrabudgetary units, nonprofits and households represent a major component of expense. They took an erratic course through FY2014, averaging $9.7 million, but like all other elements of expense rose dramatically during the last four years, averaging $17.3 million and attaining a record $20.4 million in FY2017. Other expense has been relatively minor with the exception of payment for Majuro landowner easement rights, which peaked at $3.8 million in FY2018 (see following chapter for greater detail).

Nonfinancial assets: In the case of nonfinancial assets, or fixed-capital formation, capacity limitations restrained expenditures at the start of the amended Compact. As these were overcome, expenditures rose rapidly and peaked in FY2007. From FY2008 onward, Compact infrastructure-grant awards declined, which is reflected in outlays on fixed assets. In FY2014 and FY2015, the moratorium on the use of the Compact infrastructure grant led to very low levels of investment infrastructure. However, the moratorium has now been lifted, and in FY2017 infrastructure grants returned to normal levels and outlays on fixed assets rose significantly, although in FY2018 utilization of infrastructure funds abated. Total outlays on fixed assets have averaged about $3 million higher than Compact infrastructure-grant awards, reflecting use of other funding sources, including Taiwan annual project grants.

FINANCING

Financing account composed of minor elements[2]: The financing account in the RMI in general displays few discernable trends. The small overall fiscal surplus/deficit, averaging 1 percent of GDP during the FY2004–FY2013 period[3] and more recently averaging 3.4 percent since FY2014, has been financed through a

2 The financing account in FY2011 warrants special explanation. The interested reader is referred to prior versions of the Economic Review.

3 FY2005 excluded because of a large capital transfer to the CTF.

series of minor changes in financial assets and liabilities. The major financial claims affecting the government in the RMI are domestic accounts receivable/payable, foreign accounts payable/receivable (reflecting operating of grants), domestic and foreign deposits, and external-debt drawdown and repayment. In most years, the RMI makes external-debt repayments, currently close to $3 million. It made periodic loan drawdowns before the imposition of the grant-only status. Since FY2014 the RMI has operated a growing level of fiscal surplus, reflecting the strong performance in revenues and lack of capacity to fully expend the budget. The additional resources have generally led to a buildup in foreign deposits.

4. Public Sector Management and Adjustment

At the onset of the amended Compact, the RMI adopted a medium-term framework for preparing the annual budget and for requesting resources from the United States under the sector grants. However, while the Medium-Term Budget and Investment Framework (MTBIF) approach was written into the amended Compact, and the framework was initially updated annually, the process was not adopted as a meaningful budget-planning tool. With support from the PFTAC, the RMI is attempting to improve the medium-term budgeting exercise, revenue forecasting and expenditure planning.

- In 2010 the RMI invited the PFTAC to assist the nation in preparing a PEFA self-assessment for the national government. Subsequently, the RMI underwent a formal external PEFA assessment, and, in collaboration with the government, the PFTAC prepared a road map for 2014–16. The PEFA road map forms an important part of PFM reform in the RMI and underpins the ADB PFM project to support strengthening the Ministry of Finance.
- The government of the RMI prepared and published in May 2014 the National Strategic Plan (NSP) 2015–17. The NSP is only a broad statement of government policy and has not provided the overarching framework to bring together the nation's long-term development objectives with the annual budget formulation that was lacking in the design of the original amended Compact planning system.
- Without an active set of guiding policies enacted in law, fiscal management in the RMI appears to be set on a day-to-day basis, with the level of expenditures set by revenue availability. There is a clear need for the RMI to consider a fiscal-responsibility framework to guide day-to-day fiscal management.
- During the amended Compact, the RMI has endorsed a set of reform and adjustment processes: the CAP, the tax and revenue reforms, and more recently the DMP. However, all of these efforts have so far failed to bring about meaningful reforms.

4. Public Sector Management and Adjustment

A. Public Financial Management

THE MEDIUM-TERM BUDGET AND INVESTMENT FRAMEWORK

The MTBIF: At the onset of the amended Compact, the RMI adopted a medium-term framework for preparing the annual budget and for requesting resources from the United States under the sector grants. Implementing PFM typically includes two components: the medium-term financial framework (MTFF) and the medium-term expenditure framework (MTEF). The MTFF is concerned with setting the overall fiscal envelope in which the budget is formulated, while the MTEF is concerned with the allocation of public resources—that is, expenditures—in accordance with delivery of specified outputs. Both are set in the medium term.[1] Reflecting a PFM approach to budgeting in the Compact and consisting of both an MTFF and MTEF, the RMI system was termed the MTBIF.

The medium-term framework was written into the language of the Compact in the following requirement:

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

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

MTBIF not integrated into budgeting: However, while the MTBIF approach was written into the amended Compact, and the framework was initially updated annually, the process was not adopted as a meaningful budget-planning tool or active component of fiscal and macroeconomic planning. There was a lack of institutional capacity to build and maintain the MTBIF within the EPPSO. The MTBIF was originally prepared by nonresident consultants, and there were limited local staff capable of managing, updating or communicating the results of the process to policy makers during the budget cycle. As a result, the MTBIF approach has not been adopted as an active component of the budget process or component of fiscal and macroeconomic management.

The Fiscal-Management Model: Reflecting the need to fulfill the terms of the Compact and prepare the MTBIF, the RMI submitted to the United States in FY2013 the Fiscal Management Model (FMM) to replace the MTBIF. The FMM was initially developed by the ADB to provide a very rudimentary framework to determine the fiscal-envelope and expenditure projections. However, like its more comprehensive predecessor, the RMI had not developed capacity even to maintain this simplified variant.

PFTAC and revenue forecasting: In more recent budgets, the PFTAC provided assistance to the RMI to improve the medium-term

1 In today's parlance used by the World Bank and IMF, the MTEF is frequently taken to refer to both the revenue and expenditure components of the system.

budgeting exercise, revenue forecasting and expenditure planning, in essence ditching the earlier frameworks and the FMM. Projections of the required economic variables were drawn from the Long-Term Fiscal and Economic Framework (LTEFF).[2] Government revenues were forecast in relation to the projections of the LTEFF, and key variables such as fishing fees were projected in consultation with the appropriate agencies. Expenditures were drawn from departmental budgets with explicit identification of implications of prior budgets (budget tails).

A new budget book: For the FY2018 budget, including discussion with the JEMFAC, a budget book was prepared. The document contained a discussion of the legal framework of the budget, a discussion of the basis and risks of the revenue forecasts, expenditure projections and departmental budgets. While the budget book was rudimentary in nature, it contained the basis of a modern approach to medium-term budgeting. With further PFTAC support, a departmental template was developed for the FY2019 budget to specify expenditures by category and output with revenues over the medium term.

Capacity limitations: While an improved framework for budget preparation is highly desirable, the severe capacity limitations in the ministry need to be recognized. Staffing levels are weak and pay levels in government low by public sector standards, with qualified staff attracted elsewhere. Maintaining monthly bank reconciliations and preparations for the annual audit has proven hard to achieve. The ADB has initiated $2 million of TA to support PFM and capacity building in the ministry. Bank reconciliations and audits are now timely. However, this effort has yet to extend to budget preparation.

THE NATIONAL STRATEGIC PLAN 2015–17

The government of the RMI prepared and published the National Strategic Plan 2015–17 in May 2014 with support from the UN. It was developed using a collaborative process, with representation from stakeholders and all segments of the RMI economy. In essence, the NSP is a consolidation of policy statements, plans and miscellanea from government departments, government agencies and a variety of segments of the RMI community. The executive summary of the NSP states:

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

NSP is a list of aspirations: It might be tempting to see the NSP as an adjunct to the MTBIF or the emerging medium-term framework. However, the NSP is more a list of aspirations than an operational document for use in budgeting. Only in the case of the Education Department does the NSP provide a performance matrix, containing strategies, outcomes and monitoring indicators. With the limited manpower available to the RMI, it is difficult to envisage extending the NSP into a more meaningful document and fulfilling the annual updating required. At present, the NSP is only a broad statement of government policy and not the overarching framework to bring together the nation's long-term development objectives with the annual budget formulation that was lacking in the design of the original amended Compact planning system.

Need for anchor to medium-term budgeting: The NSP has now expired, and the government is preparing a follow-on framework, 2020–30. The United Nations Development Program prepared an Economic Policy Statement, which has been endorsed by the cabinet. However, before the NSP is updated, a critical analysis of the former plan is required so that future editions may provide the type of planning document needed as the basis for long-term

2 See chapter 9, "The Long-Term Economic Outlook."

planning and an anchor to the medium-term budgeting exercise.

PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY

RMI adopts PEFA: In late 2010 the RMI invited the PFTAC to assist the nation in preparing a PEFA self-assessment for the national government. The PEFA is a framework for assessing PFM and was originally developed by the World Bank and a group of international donors in 2001; it now has its own secretariat at the World Bank with a latest upgrade published in 2016.[3] It has been implemented in many countries and provides an objective yardstick by which countries can assess and improve their PFM performance. The framework now has seven broad categories, each of which is further subdivided, with a total of 31 components in all. The scoring system is based on international standards and provides a precise measurement system, suitable for monitoring.

Road map prepared: In December 2011 the RMI underwent a formal external PEFA assessment. A team of assessors comprising the PFTAC, the World Bank and members of the RMI government, assisted by a PEFA expert, completed the assessment. The cabinet adopted the report and directed the government to request the PFTAC to compile a PFM "road map." In collaboration with the government, the PFTAC prepared a road map for 2014–16, which was endorsed by the cabinet in August 2014. The PEFA road map forms an important part of PFM reform in the RMI and underpins the ADB PFM project to support strengthening the Ministry of Finance. It is also understood that as part of an EU sector-reform contract with the RMI government, to provide budgetary support for the reform of the energy sector the government committed to PFM reforms for which the PEFA will provide the monitoring framework.

FINANCIAL PERFORMANCE

The performeter: While the PEFA provides the main assessment method of PFM performance, the Graduate School has provided a related measure of financial performance known as the performeter.[4] The performeter is an analytical tool that takes a government's financial statements and converts them into useful and understandable measures of financial performance. The performeter uses financial ratios and analysis to arrive at an overall rating of 1–10, which indicates the overall financial health and performance of a government. In this review, the standard performeter has been modified to fit the status of an independent nation rather than to fit the nature of US–affiliated insular areas. Some of the measures relate to short-term factors reflecting performance at different points of the product cycle. Others are more long term in nature, reflecting structural issues. It should be noted that the financial-performance measure reflects the underlying financial policies of the nation, unlike measures such as the PEFA that are more system- and management-orientated, although there is overlap between the two systems.

Fiscal strategy to fit expenditures within the fiscal envelope: Table 8 provides the list of nine measures used in the assessment and scores. Fiscal balance is the level of fiscal surplus/deficit as defined in the GFS divided by the level of GDP (scored on the interval −10 to +10 percent). The table indicates that the overall fiscal position improved in the early years of the amended Compact but since FY2008 has oscillated. Given the close proximity of expenditures to revenues, this suggests that fiscal policy has been operated to fit expenditures within the fiscal envelope. The size of government, the ratio of expenditures (including fixed assets) to GDP (scored on the interval 0 to 100 percent), has remained unchanged through the period. Dependency is a measure of how much revenue is derived from local revenues (scored on the interval 0 to 100 percent). Dependency varied little during much of the period, but during the last few years it has shown significant improvement, reflecting growth in fishing-fee incomes. Tax effort is simply the ratio of taxes to GDP (scored on the interval 0 to 30 percent) and has shown hardly any signs of change. The tax regime in the RMI is inherited from Trust Territory days, and tax effort has traditionally been weak. The need for tax reform and modernization is addressed later in this chapter.

3 See https://pefa.org.

4 See http://www.pitiviti.org.

Table 8 Fiscal performance, FY2004–FY2017

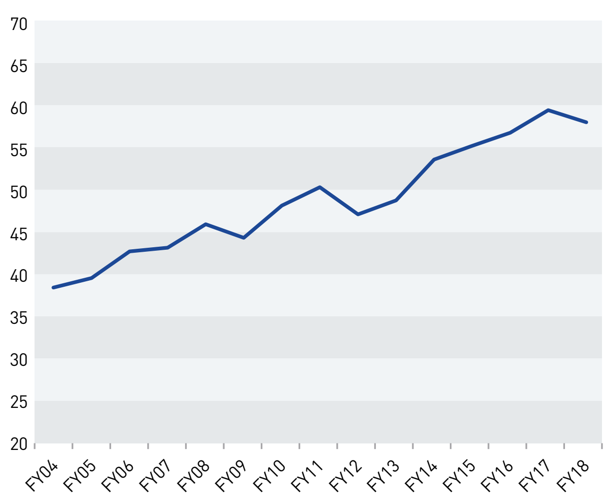
	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Fiscal balance	4	6	5	5	7	6	7	6	5	5	7	6	7	7	6
Size of government	6	6	6	6	6	6	6	6	6	6	6	6	6	6	6
Dependency: revenue independence	4	3	3	3	3	3	3	3	4	4	4	5	5	6	5
Tax effort	5	6	6	6	6	5	5	5	5	5	5	5	5	5	5
Indebtedness	0	1	1	2	2	2	3	2	3	3	3	3	4	5	5
Fund balances	5	4	4	2	3	3	4	5	5	5	5	5	6	6	6
Financing margin	3	4	6	6	6	7	7	6	6	6	7	7	7	8	8
Capital-asset condition	3	3	5	5	5	5	5	5	5	5	5	5	4	4	4
Liquidity	4	2	2	3	3	3	3	6	5	5	7	8	7	7	7
Overall	**38**	**40**	**43**	**43**	**46**	**44**	**48**	**50**	**47**	**49**	**54**	**55**	**57**	**59**	**58**

Fund balances improve: Indebtedness is the ratio of central-government debt to GDP (scored on the interval 0 to 50 percent), which has fallen from about 48 to 25 percent and has clearly improved. Fund balances measures the ratio of unrestricted funds of the government's general fund to total revenues and is a key measure for finance officers in US public accounting systems (scored on the interval −10 to +50 percent). The trends reflect the impact of the deteriorating position during the financial crisis and significant improvements since that time. The score is short term in nature but also reflects the degree of fiscal discipline. The financing margin indicates how much of a government's assets is represented through issuance of debt (scored on the interval 0 to 100 percent). Reflecting the increase in assets of the government and relatively stationary level of debt, this ratio has improved dramatically.

Liquidity ratios very low but have improved: The capital-asset condition is an indicator of useful life of the fixed assets of the government. It is based on the ratio of the total value of depreciated assets against original cost (scored on the interval 0 to 100 percent). In the RMI's case, the ratio improved in the early years, reflecting large capital projects, but has trended downward as assets have depreciated. Liquidity is measured by two measures: the ratios of current assets to liabilities (scored on the interval 0 to 200 percent) and the ratio of cash to current liabilities (scored on the interval 0 to 100 percent). These are short-term measures, and the trends reflect the point of the product cycle. The combined score indicates a low value in the initial years of the amended Compact, reflecting a tight cash flow position and improvement more recently as the fiscal position has improved.

Financial performance improves: Finally, the overall results are indicated in figure 26. The results indicate that the RMI score has improved significantly during the amended Compact, rising from a score of 38 in FY2004 to 58 in FY2018. The main drivers of the improvement have been a fall in indebtedness and improved fund balances, financing margin and liquidity position. While the modified performeter provides largely an accounting measure of financial health, the results clearly indicate that the RMI has made significant progress.

Figure 26
Overall fiscal performance (score 1–100)



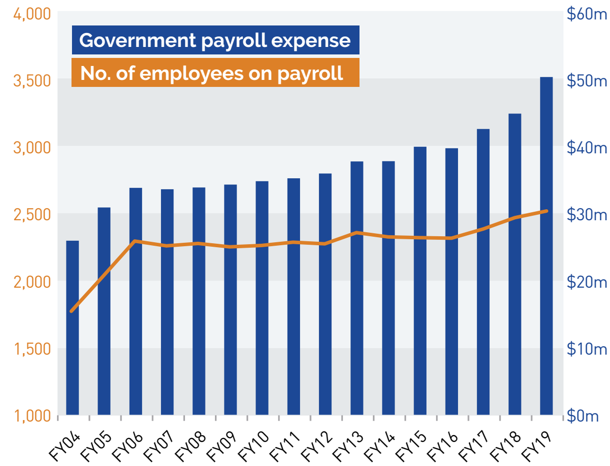
PUBLIC SECTOR PAYROLL

Payroll returns to former levels in amended Compact: Payroll is a critical component of financial management, and in this section recent trends in the RMI government's payroll are analyzed. Payroll grew significantly at the end of Compact I after the government had closed out the ADB Public Sector Reform Program (PSRP) when it made significant reductions in payroll. Additional resources enabled civil servant payroll to return to its former levels and expand further with the new funds from the amended Compact and other sources. Figure 27 indicates recent trends in the number of civil servants and payroll costs. The number of civil servants increased from 1,770 in FY2004 to 2,515 in FY2019, an annual rate of 2.4 percent. Payroll costs rose at an average rate of 4.5 percent over the period. These trends have been influenced by a number of extraordinary items that require incorporation into the analysis.

Payroll at Ministry of Education (MOE): A significant portion of the growth in the payroll cost and in employee numbers has been at the MOE. In FY2004, employment at the MOE was 654, and it expanded to 1,114 by FY2019. More than 200 of these employees were hired in FY2006 to support the implementation of the SEG-funded kindergarten program, which replaced the former federally managed Head Start program. Once allowance is made for this anomaly, expansion in education payroll during the FY2004–FY2019 period was 263 positions, or an annual average increase of 2.3 percent. Where recruitment has taken place, it has supported delivery of frontline services—for example, with increases in teaching staff and elementary school services and support.

Payroll at Ministries of Health and Transportation: Substantial growth in payroll has come from outside the Ministry of Education. Employment at the Ministry of Health increased by 178 positions, from 421 in FY2004 to 599 in FY2019 (see table 9). Significant staff increases occurred in the Majuro and Kwajalein hospitals, suggesting a greater emphasis on curative care. The operations of the Ministry of Public Works were scaled back in the late 1990s, and the ministry had adopted a role focused on oversight and regulation. However, this policy was reversed, and, during the amended Compact, the Ministry of Public Works took on a more proactive role in outer-island project implementation and maintenance. The Ministry of Transport and Communications was also scaled back in the late 1990s, with the intention of privatizing outer-islands shipping services. However, this policy was not successful, and the services were initially brought back into the public sector and later transferred to the newly formed MISC.

Figure 27
RMI government payroll cost and number of public servants



Payroll numbers moderate, but wage costs increase: Returning to the overall trends in payroll and adjusting for the transfer of teachers from Head Start to the SEG, the size of the public service increased at an annual rate of 4.0 percent over the FY2004–FY2008 period. Since that time, the size of the public sector has grown modestly, adding another 241 jobs, an annual rate of 0.9 percent. Although expansion in government payroll has moderated since FY2008, total government-payroll costs have continued to expand, reflecting overall increases in wage rates. While a policy of freezing payroll costs has been in place during much of the period, a hidden 2.7 percent annual wage drift has occurred between FY2008 and FY2019. In FY2013 salaries for teachers and nurses increased because of improvements in teacher qualifications and higher pay scales to retain nurses who had been leaving to take better pay and conditions in other countries. Moderate annual increases in wage rates can represent sound policy intended to attract and maintain a qualified workforce. However, this pattern has

Table 9 RMI Government number of public servants by department, selected years

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
President & Cabinet	20	25	26	31	28	29	28	27	26	29	25	23	24	47	49	33
Chief Secretary Office	16	20	20	22	24	28	30	23	21	21	24	23	23	25	28	27
Special Appropriations	0	0	0	0	17	0	0	0	0	0	0	0	7	3	0	0
Council of Iroij	13	15	15	15	14	16	15	16	15	16	15	16	16	16	16	16
Nitijela	29	42	45	45	40	48	47	47	41	44	45	44	41	46	47	49
Auditor General	10	10	10	9	7	7	8	9	9	11	13	15	18	17	17	16
Foreign Affairs	29	35	33	35	34	37	37	34	32	38	39	35	35	39	41	38
Public Service Commission	10	12	13	14	15	15	15	16	15	15	15	15	17	17	16	17
Judiciary	25	32	38	39	36	34	31	37	38	40	39	38	36	35	37	39
Attorney General Office	24	25	25	24	21	21	22	24	24	23	24	25	22	24	26	26
Ministry of Education	651	730	984	987	1,024	1,025	1,020	1,044	1,052	1,088	1,054	1,066	1,056	1,061	1,087	1,114
Health and Environment	421	508	507	521	507	481	487	502	501	508	501	487	490	520	561	599
Transport and Communications	102	110	90	42	18	18	16	17	19	18	17	16	16	16	15	15
R & D	23	24	26	29	27	30	32	31	34	33	31	31	29	28	35	33
Internal Affairs	58	59	62	60	74	74	86	86	85	81	80	75	78	72	70	68
Justice	145	164	164	161	161	168	168	157	152	183	194	202	203	201	194	190
Finance	89	110	116	114	118	106	108	109	107	108	106	99	102	107	110	114
Public Works	92	92	97	89	88	88	87	79	76	72	71	74	67	79	86	90
Epa	13	17	18	17	18	18	17	18	18	19	20	19	19	17	18	20
Compact II Capital	0	0	2	2	3	5	5	7	6	7	9	14	14	11	12	11
Total	1,770	2,030	2,291	2,256	2,274	2,248	2,259	2,283	2,271	2,354	2,322	2,317	2,313	2,381	2,465	2,515

Notes
1 Based on first 2 quarters of FY2018

added to the overall cost of government in an environment with limited fiscal space.

Significant scope for rightsizing: Although the recruitment process is under control, the extent of the expansion in government since the reduction in force (RIF) at the end of the 1990s suggests significant overstaffing. After the RIF, there were 1,675 public servants (including an allowance for the SEG), compared with the current level of 2,515. Thus, it appears there is considerable scope for rightsizing to establish a level of staff that adequately maintains government services.

Payroll by fund: Beyond the general analysis of trends in the civil service, employment by funding source adds further insight. Table 10 indicates the level of public-servant employment by fund type. In addition to the transfer of employees from Head Start to the DOE under the SEG in FY2006, 120 teachers were transferred from the Compact education-sector grant to the general fund in the third quarter of 2013 because of a JEMFAC resolution. Bearing these changes in mind, the general fund has grown by 209 jobs, or 1.3 percent per annum, and, in the case of the Compact sectors, by 331 jobs, or 2.7 percent per annum. A major growth area has also been in federal-programs employment, which has grown by 51 jobs, or 2.1 percent per annum. While analysis indicates the amended Compact allowed significant growth at the start of the period through the sector grants, in later years the general fund together with federal programs, which are not subject to the same fiscal constraints, has provided the major source of growth.

FISCAL RESPONSIBILITY

Fiscal management run day-to-day: While the indicator of overall financial performance presented in an earlier section indicates that things have improved, many of the individual indicators suggest the position remains weak. The overall measure of fiscal balance indicates a range of outcomes, from −1.6 to +3.5 percent of GDP (before the fishing-fee boom in FY2016), and is unrelated to the current point in the economic cycle. For example, the government ran surpluses during the financial-crisis years of FY2008–FY2009 but ran deficits in FY2012 and FY2013 when conditions had improved. Without an active set of guiding policies, fiscal management appears to be set on a day-to-day basis, with the level of expenditures set by revenue availability.

Liquidity tight but improving: Cash management has been weak, although it has improved in the last few years. Cash to current liabilities, the quick ratio, averaged 7 percent during the financially constrained period between FY2005 and FY2010, an amazingly low ratio for a sovereign government. Since then, the quick ratio has improved, recording a value of 51 percent in FY2015, but indicates a very limited capacity, if any, to manage financial shocks or natural disasters.

Fiscal performance in FY2013: The fiscal outturn and performance for FY2013 provide a good example of fiscal behavior and adjustment to a period of surplus. During the year, the RMI received significant additional unconditioned budget support from the ADB ($5 million) and World Bank ($3 million), along with strong incremental growth in fishing fees of $4 million. However, despite the large increase in revenues, representing 12 percent of GDP, expenditures also grew strongly, with increases in payroll and continued SOE subsidies.

Expenditures rise to match large increase in revenues: With the advent of the PNA and the VDS, surplus revenues have boomed. Government drew down $7.9 million in fishing-fee revenues from the MIMRA in FY2013, which rose to $12, $15 and $26 million in the following three years. In FY2017 the government executed an extraordinary budget of an additional $13 million above the normal annual budget; the additional funds were financed out of the accumulated MIMRA reserves. Thus, a total of $40 million was appropriated in FY2017 from the MIMRA compared with a level of just $2 million back in FY2010. In FY2018 the use of MIMRA funds fell back to $29 million without the use of past savings. However, expenditures had risen to such an extent that the overall balance remained unchanged in FY2010. The ability of the budgetary process to absorb additional funds, with a largely automatic adjustment of expenditures to revenues, indicates an undisciplined fiscal environment and the need for a guiding policy framework.

Need for fiscal responsibility: Clearly, the RMI needs a legislative framework to guide fiscal responsibility, both in the short term and the longer term. Many countries have enacted a fiscal-responsibility framework whose primary objective is to entrench sound fiscal policies. As indicated in a recent IMF primer: *The primary function of fiscal rules is to avoid deficits and procyclical biases by constraining the government's use of fiscal discretion.*[5] On the upside, governments have a tendency to expand expenditures, and on the downside to restrict capital outlays, both of which are contrary to sound fiscal management. The World Bank in an earlier work explains fiscal responsibility:

> *The first main provision involves setting fiscal objectives in a two-step process by requiring adherence to "Principles of Responsible Fiscal Management" and mandating preparation of an annual Budget Policy Statement by government. The "Principles of Responsible Fiscal Management" mandate that debt, spending and taxation be maintained at "prudent" levels. Any deviation from the principles requires explanation by the Minister of Finance as well as an explanation as to how and when government will return to the principles. The Budget Policy Statement requirement obligates government to make an annual statement of fiscal intentions for the next three years and their long-term fiscal objectives, as well as the consistency of fiscal intentions and objectives with the "Principles of Responsible Fiscal Management".*

An outline of a fiscal strategy: As a result of these considerations, the RMI government

5 IMF Fiscal Affairs Department, 2017, How to Select Fiscal Rules: A Primer, 2017, Washington, DC.

Table 10 RMI Government number of public servants by fund, selected years

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	Annual % change
General fund	924	987	1,041	995	985	1,006	1,010	1,017	1,000	1,052	1,050	1,051	1,059	1,097	1,133	1,120	1.3%
Compact II	764	810	997	991	1,004	996	997	1,006	1,012	1,040	1,019	1,023	1,022	1,047	1,095	1,146	2.7%
Special revenue	50	51	48	48	54	31	29	36	32	37	29	28	27	26	26	27	~
Federal grant	158	170	189	207	204	202	207	213	216	217	217	213	204	208	209	215	2.1%
ROC	18	14	12	11	23	9	9	6	8	2	1	2	1	0	1	1	~
Total	1,914	2,032	2,290	2,256	2,273	2,247	2,260	2,282	2,274	2,353	2,321	2,319	2,314	2,380	2,468	2,513	1.8%

initiated a process to develop a long-term fiscal-strategy and fiscal-responsibility framework. While the process is ongoing and yet to be considered at the political level, the following key elements were outlined during planning sessions in 2019.

1. **The goal of fiscal strategy**: The following objectives are identified as the major components of fiscal strategy:
   - **Economic and financial stability**, defined as long-term fiscal sustainability such that sustainable revenues are sufficient to finance total expenditures without entailing a reduction in net economic and environmental wealth.
   - **Encourage maximum use of resources**: Bring the maximum use of economic resources, including land, capital and labor, into efficient production.
   - **Savings and investment**: Encourage generation of savings, and, through intermediation of the financial sector, channel it into efficient investment to accelerate the rate of economic growth and development.
   - **Economic and social equity**: Encourage an equitable distribution of resources and inclusive economic growth among the population.
   - **Development of the private sector**: Support private sector development through investment in infrastructure and improvement in the regulatory environment.
   - **Taxation**: Develop a tax regime to support the efficient allocation of resources, economic development, savings and investment.
2. **Fiscal responsibility**: It is proposed that the government enact a fiscal-responsibility framework in law. That fiscal-responsibility framework would form the foundation of fiscal governance and call for a (rolling) Long-Term Fiscal Strategy (LTFS). The framework is anticipated to include (i) the principles of responsibility as informed by international best practice adapted to the RMI, and (ii) transparent and accountable budget formulation, reporting and monitoring processes. The principles of fiscal responsibility would commit the RMI to manage fiscal risks prudently by applying five principles:

i. Maintain prudential levels of recurrent expenditures within available revenues consistent with the objectives of the long-term fiscal strategy.

ii. Manage debt prudently.

iii. Manage the tax regime to best fit the structure of the economy and to allow for predictability over time.

iv. Manage reserves and insurance coverage to offset cyclical volatility, natural disasters and the impact of climate change.

v. Manage capital expenditures to achieve rising national net worth over time.

3. **Principles of fiscal responsibility**

i. **Fiscal risk**: The following elements have been identified as the critical components of fiscal risk:

a. **Countercyclical reserve**: The operation of fiscal policy during the amended Compact has experienced periods of substantial cash flow shortfalls, including failure to service accounts payable and external debt repayment. It is proposed the RMI set up a countercyclical reserve equivalent to three months of general-fund revenues, funded from general revenues, that can be accessed during periods of cyclical downturn and cash flow shortfalls. Clear guiding principles on access and replenishment of the reserve would be needed.

b. **CTF distribution and policy**: Analysis of the CTF indicates that it is unlikely to reach a level sufficient to provide a level of distributions after FY2023 to replace the annual sector grants. The LTFS proposes the RMI adopt rules that support a prudential approach to CTF withdrawals. Based on current performance of the CTF, this implies reducing drawdowns from the projected $27.1 million of sector grants in FY2024 to $19.9 million, a 25 percent cut. In the intervening period until the end of the amended Compact, the RMI would devote these funds to either the general-fund reserve or infrastructure fund.

c. **SS liabilities**: Significant reforms to SS have been undertaken and improved the likelihood of sustainability. However, based on current projections, eventual collapse has not been averted but pushed out in time. In the absence of sufficient reform, the government has committed to continued funding of the system, contributing an average of $3 million in recent budgets. The LTFS proposes that the government continue to transfer resources of this magnitude until such time as further reforms are enacted or the basis of the projections are re-estimated and improved.

d. **SOE reform and management**: The large inefficient and poorly performing SOE sector poses a significant fiscal risk. The risk has grown in recent years with a ballooning level of subsidies. The government has passed an SOE law that requires commercialization of SOEs and adoption of full cost recovery with defined CSOs where the need exists. An SOEMU has been established, and reform has been initiated, but the pace of change needs accelerating if serious change in SOE culture is to be achieved. This will take time and continued donor support.

e. **Compact adjustment after FY2023**: In addition to the annual sector grants, the Compact provides a series of other benefits including access to US federal programs, the SEG, Pell grants, the FAA, the Federal Communications Commission and many others. While the economic assistance provided to the RMI covered under the amended Compact expires in FY2023, the continuation of federal programs and services (provided for under subsidiary agreements) and future access after FY2023 are not known with clarity. In FY2017 the total value of these programs amounted to $19.6 million, or 9.4 percent of GDP. In a worst-case scenario, termination of these programs would entail a significant fiscal adjustment. An important ingredient of the LTFS is to outline the adjustment effort required that can be incorporated into the annual budget framework.

ii. **Medium-term expenditure ceilings**: The primary objective of adopting a fiscal-responsibility framework is to set expenditures within the medium to longer term in accord with the overall principles and identified risks in the LTFS. As part of fiscal responsibility, the government would report on the method of determining expenditure targets and report on any departures from these principles. At the current time, with booming fishing royalties, this would imply running fiscal surpluses and accumulating savings.

iii. **Tax reform**: Tax reform is a central piece of the fiscal strategy. The current regime is outdated, inefficient and distortionary. It requires replacement with a modern efficient and equitable system. The main ingredients of the fiscal strategy are the following:

- A **Marshall Islands consumption tax** (essentially a VAT) to replace the existing general import tax on goods at the c.i.f. level and bring consumption of services into the net.
- A **net profits tax** (NPT) would be introduced for all registered businesses above a threshold ($100,000) to replace the GRT.
- Special rates of **excise taxes** would be levied on alcohol and tobacco, both on imports and local production, and would replace the current special import taxes.
- The current **wages tax** would be reformed to restructure the current thresholds and introduce a higher rate for high-wage earners.

iv. **Debt management**: External-debt management in the RMI has been weak and, although now falling to sustainable levels, has at times posed a threat of debt stress. No formal debt framework exists. The fiscal strategy proposes a debt-management framework that would be enacted by legislation and provides vetting principles and evaluation and monitoring mechanisms.

v. **Financing of infrastructure**: The RMI has adopted a policy of financing capital expenditures from grant aid or debt. This has resulted in infrastructure investment declining as a share of GDP. The fiscal strategy proposes the government establish an infrastructure reserve fund to ensure infrastructure is maintained at adequate levels to support a growing economy. The LTFS proposes the National Infrastructure Investment Plan be maintained and used as the principal framework for project selection.

4. **Budget, compliance and reporting requirements**

The budget process and tools called for under the fiscal-responsibility framework are anticipated to follow a cycle along the following lines:

i. Use of the LTEFF to establish a fiscal envelope on an annual basis

ii. The budget call

iii. An annual economic and fiscal update, including economic and fiscal forecasts, statement of tax-policy changes, and key assumptions under which the budget was formulated

iv. An annual budget statement updating the medium-term fiscal strategy with assessment of the achievement of the principles of fiscal responsibility, presented at the time of budget delivery

v. Half-yearly economic and fiscal update of key fiscal tables to inform late-year budget adjustments, if any

B. Fiscal Adjustment

RMI initiates fiscal adjustments in response to global financial crisis: In response to the emerging world financial crisis in 2008, the onset of the global recession, and, most important, the imminent financial collapse of the MEC, the cabinet created two groups and commissions tasked with fiscal-reform initiatives. In April 2009 the RMI CAP Advisory Group was created to develop and design the CAP. The program would address the immediate needs of fiscal stability while also enhancing medium-term prospects for private sector–led economic growth. The second group created by the cabinet was the Tax and Revenue Reform and Modernization Commission (TRAM), which was tasked with developing a proposal to reform the existing revenue system and strengthen compliance and collections. Arising out of these reform initiatives, requests were made to the ADB for support through the PSP, aimed at consolidating the reform process and, in particular, providing resources to refinance the MEC debt on concessional terms. While the CAP reform was initiated several years ago, it has yet to be implemented and still remains relevant today. The TRAM reform, although actively considered in the RMI for some time, went on the back burner as elections approached. Both the CAP and the TRAM are described in the following sections.

THE COMPREHENSIVE ADJUSTMENT PROGRAM

Need for long-term fiscal sustainability: The minister of finance, with the endorsement of the cabinet, created the CAP Advisory Group on April 22, 2009. The policy makers identified two broad goals for the program: (i) to put the government on a path toward long-term fiscal sustainability; and (ii) to provide the government with a program that could better guide its relations with the external donor community. The CAP Advisory Group outlined general principles of reform, but these were limited to cost reduction and a detailed examination of the major areas of expense. Table 11, reproduced from the CAP report, indicates a range of potential savings by expense category. The list will not be discussed in detail, with the exception of two major categories relating to the civil service and SOE subsidization.

CAP recommends RIF: In the RMI, the civil service represents nearly 40 percent of the cost of current operations. The advisory group recommended implementing an RIF ranging from 50 to 400 civil servants, with cost savings of $1.7 to $4.9 million. It is clear that any RIF would have to come from the general fund, as other categories are protected by dedicated funding sources. At the time of the reforms in the late 1990s (implemented through the PSRP), the general fund supported about 600 staff outside of education and health and was able to maintain normal government operations. Since that time, employment financed by the general fund has grown by about 500, which indicates the level of resizing that might be accomplished. The cost savings represented by this amount would in today's terms be equivalent to about $10 million.

SOE reform: The CAP study did not directly make any recommendations on the value of savings that could be generated from a reduction in subsidies to the SOEs and transfers to other government agencies. However, the CAP recommended a review of the SOE sector, which was subsequently completed with ADB support, and the development of a comprehensive approach. At the end of 2015, Bill No. 10, known as the State Owned Enterprise Act, was passed into law (PL 2015-45) and provided a set of best practices for operating the sector. The major provisions of the law are discussed in the section on SOEs below. As outlined in the foregoing parts of this review, SOE cost is a major and rapidly growing area of expense and must be a key component of PFM reforms.

CAP not implemented: Overall, the CAP group recommended reducing expenditures by $7 to $8 million over a one- to three-year period to address the structural deficit existing at the time of the CAP recommendations. However, while certain legislative changes have been enacted, none of the recommendations have been implemented or incorporated into the annual budget process. While the fiscal position has changed significantly in recent years and a structural deficit has shifted to one of surplus, the CAP exercise remains relevant to identifying

Table 11 CAP Advisory Group proposed savings by expense category

Reform areas	Minimum savings (US$ millions)	Maximum savings (US$ millions)
Civil service	1.70	4.90
Nitijela member compensation	0.14	0.17
Housing allowances	0.25	0.27
Electricity allowances	0.50	1.52
Leased and rental housing	0.07	0.15
Utility bills	0.25	0.75
Communications	0.05	0.10
Vehicles	0.05	0.10
Fuel	0.07	0.10
Travel and per diem	0.10	0.20
Professional services	0.03	0.06
Grants and subsidies	0.60	1.80
Organization/facilities consolidation	0.15	0.30
Total	**3.96**	**10.42**

areas of reform and savings to promote a more efficient public sector that will be needed after FY2023, when the fiscal environment is uncertain and may be less favorable.

TAX AND REVENUE REFORM AND MODERNIZATION COMMISSION

The cabinet created the TRAM on July 11, 2008, complementing the creation of the CAP Advisory Group. While the CAP was created to investigate ways to save costs in the operations of the government, the TRAM was created to

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

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

- be transparent and certain;
- be effective and efficient to administer;
- be simple and broad-based;
- be fair and equitable;
- be financially neutral;
- create a low tax burden;
- be able to promote private sector development; and
- be attractive to foreign investment.

PFTAC requested to support tax reform: To support the recommendations of the TRAM, a request was made to the IMF's PFTAC for TA in developing and designing the tax-reform package. The essence of the tax reforms proposed by the PFTAC was introducing a modern tax system that is equitable, efficient and simple while raising sufficient revenue to meet future fiscal challenges. The package of reforms would not only broaden the tax base but also attempt to keep rates low. The major elements of the system included the following:

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

Administrative reform: While the PFTAC proposal outlines a set of reforms, it also stresses the need for strengthening tax administration. In particular, introducing the consumption tax (VAT) would be a key component of a modern tax system and would contribute to better levels of compliance. The PFTAC also proposed creating an independent tax authority, which would incorporate an efficient and incentivized administration not subject to public-service regulation. The tax-reform strategy and administrative reforms would provide the RMI with a tax system consistent with international standards that is conducive to business and foreign investment and is more equitable for taxpayers. The proposed reforms would also increase the revenue yield.

Business dislike of VAT: The PFTAC tax-reform proposal was well received by the TRAM and, with one major exception, was recommended to the government, largely without modification. The major exception was the introduction of the VAT, which in effect was the centerpiece of the PFTAC tax-reform initiative. The adverse reaction has been long-standing in the RMI, going back to the time of the reforms in the late 1990s (the PSRP), when the VAT was introduced without advance preparation and was subsequently repealed. Despite extensive public discussion of the tax-reform initiative, opposition is largely based on a lack of understanding of tax systems not prevalent in the United States. Granted that the business community is not known for its receptiveness to tax reform, but the widespread misunderstanding that the incidence of the VAT falls on the private sector is unfortunate.

Reforms go on back burner: Laws have been drafted for a series of tax reforms, including an NPT and a Marshall Islands consumption tax, as has the Revenue Administration Act. The intention was to submit the bills to the August 2011 session of the Nitijela, but this has continuously been delayed until the present day. A tax administrator was recruited under AusAID (Australian Agency for International Development) for a two-year period to support the process, which has now expired, and the advisor returned to Australia because of a lack of progress. With the formation of a new administration after the 2015 election, the policy was to re-examine the position of key stakeholders, namely those in the private sector, and reinitiate the process. However, with a new election due at the end of 2019, no further progress has been achieved.

ADJUSTMENT TO THE AMENDED COMPACT

Decrement plan: Bearing in mind the continuing reduction in resources implicit in the amended Compact due to the annual decrement, the United States asked the RMI to prepare a decrement-management plan over the medium term. At the JEMFAC meeting in September 2009, JEMFAC Resolution 2009-1, "Sustainability of Sector Budgets," was adopted:

> *JEMFAC resolves that the RMI Government develop a plan for managing annual decreases in Compact direct assistance and/or general fund support, and use those plans as the basis for Fiscal Year 2012 budget decisions. The plan should include an evaluation of the ability of the health and education sectors to fulfill their strategic outcomes in fiscal years 2012-2014.*

RMI fails to comply with JEMFAC resolution: The RMI did not comply with this request, and, during the following annual JEMFAC meeting in 2010, an extended version of the original resolution was adopted (JEMFAC Resolution 2010-1: "Long-Term Fiscal Planning"):

> *JEMFAC resolves that the RMI Government shall develop a report that addresses the broad range of fiscal challenges facing the RMI, which was in part the subject of JEMFAC Resolution 2009-1. Since efforts to date have not led to the timely submission of such a report prior to the August 1, 2010, deadline, JEMFAC hereby provides a list of issues to be addressed in such a report for the review of JEMFAC.*

MTBIF issued as decrement strategy: In response to the US request, the RMI issued an updated MTBIF, and in March 2011 submitted to the JEMFAC a report entitled "Decrement Strategy & MTBIF Policy Framework Paper, FY11-14." The approach adopted by the MTBIF was a simple one: to implement recent reform efforts to reduce expenditures (CAP; see above) and adopt a modern tax regime (TRAM; see above). The subsequent improved fiscal position would enable education and health expenditures adopted as priorities by the RMI government to be maintained in real terms over the medium term, as the rest of the government was scaled back. The MTBIF approach represented a rational response to the JEMFAC resolution.

FMM not accepted by JEMFAC: However, in the run-up to the FY2012 budget allocations, the JEMFAC determined that the annual RMI budget submissions were not consistent with the MTBIF commitments or the previous resolutions. As a consequence, another resolution, 2011-1, which restricted the use of Compact funds, was adopted. During the first half of 2013, the RMI adopted and submitted to the United States a fiscal-management model developed with assistance from the ADB. However, the fiscal-management model was not well developed or integrated with the expenditure side of the equation and was not considered a fulfillment of either the MTBIF requirement or the JEMFAC resolution calling for long-term fiscal planning. As a result, the JEMFAC issued yet another resolution, 2013-2, this time proposing ratio-based allocation restrictions for a series of cost categories.[6]

THE DMP

RMI agrees to prepare DMP, and ministries are requested to develop list of expenditure cuts: After further discussions and delay in the release of the FY2014 budget allocations, the RMI had little alternative but to commit to the preparation of the DMP. A leadership meeting was convened in Majuro in July 2014 to craft the DMP. A month before the meeting, the various ministries and agencies were requested to prepare a budget over the remainder of the amended Compact period, FY2015–FY2023, assuming a 15 percent cut in expenditures was required to achieve long-term fiscal sustainability. Using the FY2014 budget as the baseline, the respective ministries were requested to rank in order of priority the various projects and programs under consideration for elimination or reduction in service. A prioritized and ordered list was thus drawn up, with the highest priority at the top and with reducing importance going down the list, until the 15 percent cut in expenditures was achieved for each ministry and agency.

Leadership meeting convened and requested to prioritize expenditure cuts: With the technical and expenditure-prioritized exercise complete, a two-day leadership conference was convened. At the outset, the likely pattern of economic growth and fiscal implications was presented. With an overview of the magnitude of the adjustment required, the leadership was divided during the first day into two groups, and each group was requested to come up with a redeveloped list according to their priorities. The leadership was asked to allocate the cuts into three tranches: FY2016–FY2017, FY2018–FY2020 and FY2021–FY2023. Clearly, the long-term horizon and likely changes in economic performance from that projected required that while the endorsed cuts for FY2016–FY2017 would be binding on the RMI, those for the remainder of the amended Compact would be indicative only.

6 More detail on the JEMFAC decrement issue can be found in the FY2014 Economic Review.

Leadership considers additional adjustment measures to spread the burden: With the first day of the leadership conference complete, the second day opened in plenary with a presentation of four additional, alternative measures that could be used to achieve fiscal sustainability over the remainder of the amended Compact period. The meeting was subsequently once again divided into two groups, and each group was requested to either include each further adjustment item in the program or not and, if the item was selected, to include the magnitude of the adjustment. The four alternative measures and the expenditure cuts are listed as follows and discussed below:

- Expenditure compression: reduction in ministerial expenditures
- Tax reform
- Use of MIMRA funds (fishing fees)
- Reduction in subsidies to the SOEs
- Reduction in the utility payments to Majuro landowners

Expenditure compression: The exercise was designed to implement the cuts in three yearly tranches—FY2016, FY2018 and FY2021—with the first tranche scheduled for FY2016 because of the impracticability of implementing the exercise in the FY2015 budget. In total, the leadership had proposed a $6 million reduction in expenditures over the remainder of the Compact period, representing 10 percent of the total ministerial outlays. In FY2016 the first tranche of cuts took place, with a $1.3 million reduction across government administration, education and health. Cuts of $2.5 and $2.2 million were proposed for FY2018 and FY2021, respectively, with most of the burden falling on goods and services with minor adjustment to payroll.

Tax reform: The leadership was made aware that implementing the major components of the tax-reform system—a VAT and an NPT—would take up to two years and that the earliest that the reforms might be introduced would be FY2017. While the leadership opted to include tax reform as part of the adjustment, it did not deviate from the original objective of the tax-reform initiative of revenue neutrality. Therefore, the fiscal impact of the introduction of the tax reform could be minor in FY2017. However, during the latter part of the remaining years of the amended Compact, the reformed system could be expected to be revenue positive, as the economy moved to a more efficient and buoyant tax system. A revenue gain of $1.2 million was projected for FY2023.

Programming of fishing-license fees: Receipt of fishing fees by the RMI has grown rapidly in recent years. From a level of $3 million in FY2010, the known revenues of the MIMRA had grown to $15.7 million at the time of the DMP and attained a value of $33.9 million in FY2018. This explosive growth reflects the impact of the PNA and the introduction of the VDS. In years prior to 2010, the MIMRA resources were used to support the development and sustainability of the fishing industry. However, with the significant growth in fees and the return on a national resource, the revenues represent a major fiscal resource. However, while a minor part of the resources had been programmed into the budget, the additional fees had not formed part of the annual budgeting process. The need for fiscal adjustment thus presented an opportunity not only to address the emerging structural deficit but also to regularize the budgeting process. While the leadership adopted a transfer representing 80 percent of MIMRA resources, a bill was subsequently passed in 2016 (PL 2016-23) allocating all surplus MIMRA funds to the annual budget. In 2019 a further bill was under consideration to allocate all fish revenues to the government with the MIMRA to receive an annual transfer as part of the budget.

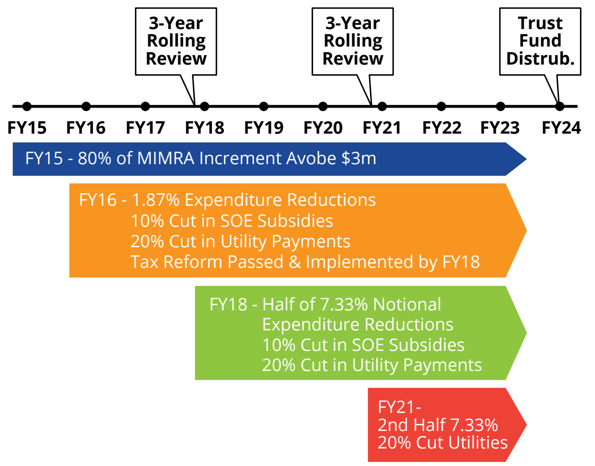
SOE-subsidy reduction: A major feature of the RMI economy is the large number of SOEs. However, little progress had been made in subsidy reduction, and the total current transfer to the sector in FY2013 was $8 million at the time of the DMP ($11.9 million in FY2018). It is not envisioned that reductions in subsidies could be made easily or simply by the stroke of a pen. However, the leadership was presented with the option to reduce the level of subsidy as part of the overall adjustment. The leadership agreed that the level of subsidy should be reduced in FY2016 and FY2018 by 10 percent in each period. The fiscal savings would amount to $0.8 million in FY2016 and $1.5 million in FY2018. In retrospect, this was a weak element of the DMP as no clearly identifiable areas of savings had been itemized.

Majuro landowner utility bills: As compensation to Majuro landowners for the use of their land for placement of utility poles to support the power grid, the government has transferred funds through the MEC to the landowners for easement rights. However, this transfer has grown rapidly in recent years, from $1 million in FY2010 to $2.1 million in FY2013 and to $3.8 million in the FY2018 audit. The transfer has grown rapidly because of the increasing cost of electricity and also an increasing number of landowners as land has been subdivided. The practice has been widely criticized. It is inefficient in that it encourages electricity wastage, and the payments are unrelated to the land on which the poles reside. The leadership was presented with the option to program a reduction over the adjustment period. Reductions of 20 percent were selected for FY2016, FY2018 and FY2021. The fiscal savings were estimated to grow in multiples of $0.4 million during the implementation years.

Projected surplus exceeded JEMFAC requirements: After each of the two groups had deliberated on the above five adjustment measures, the leadership came together in plenary, and the proposals were entered into the LTEFF to determine whether they were consistent with fiscal stability through the remainder of the amended Compact period.[7] An overall combined adjustment program was constructed from the discussions, and the result was adopted by the leadership. The implementation timeline of the DMP is summarized in figure 28. From an initial projected accumulated deficit of $47.7 million over the period and a deficit of $9.7 million in FY2023, the impact of the adjustments was projected to result in an accumulated surplus of $27.5 million and annual surplus of $4.2 million in FY2023. While the overall result clearly satisfied the needs of the DMP—the planned and sustainable adjustment to declining resources—the resulting fiscal surplus was greater than required. While not explicitly debated at the leadership meeting, it was understood the projected surplus would augment inadequate CTF levels and support the collapsing SS system.

7 See chapter 9 and appendix 2 for discussion of the LTEFF.

Figure 28
Implementation timeline of DMP adjustment measures



DMP a participatory process: While the Graduate School facilitated the conference, the choice and magnitude of adjustment were entirely in the hands of the Marshallese leadership. Following the meeting in early September, the Graduate School presented the outcome of the conference to the RMI cabinet, as some members were not present during the deliberations. The cabinet subsequently endorsed the DMP, and it was submitted to the JEMFAC.[8]

Current fiscal circumstances outpace need to implement DMP: The DMP and the leadership process were conducted at a time of limited fiscal resources and structural deficit. Since that time, with abundant fishing revenues, the fiscal position has been transformed into one of structural surplus (at least through FY2023). Implementing the DMP has thus gone on the back burner as the RMI has been able to offset the annual decrement through greater allocation of surplus funds. While the JEMFAC appears no longer to be requiring the RMI to implement the DMP, it still requires submission of the MTBIF to ensure adequate funds are allocated to maintain essential services in education and health.

8 See http://www.econmap.org for a copy of the plan.

5. State-Owned-Enterprise Reform

With high levels of subsidies and capital transfers to the SOE sector, at an average of 11 percent of GDP over the last three years, the ailing sector continues to be a major issue.

- Recent legislation in the 2015 State Owned Enterprise Act requires SOEs to operate on a commercial basis, with identification of CSOs and the establishment of the SOEMU in the Ministry of Finance. The law provides a sound framework for SOE management and should lead to an improvement in SOE performance.
- The SOEMU has now been set up in the Ministry of Finance as part of the ADB PFM effort. This will provide a critical component to assist in the effective implementation of the law, providing transparency and public accountability. Each SOE reform has been tasked to prepare a statement of corporate intent to be submitted to the Nitijela and is required to prepare a three-year rolling business plan. SOE reform is a long-term process, and establishing the SOEMU with qualified staff will take time.
- The MEC posed a significant fiscal risk at the time of the global financial crisis, but, with program loan support from ADB, it engaged in debt restructuring and reform. The program was successful, and the MEC now operates without subsidy apart from government support for outer-island power generation.
- The National Telecommunications Authority, the state-owned telecom provider, now requires subsidies from government to finance the costs of a fiber optic connection to the internet. Early World Bank–initiated sector programs failed to ignite reform, but a recent World Bank–funded study has reinitiated the effort and proposed restructuring options that include privatization.
- AMI, providing air transport to the outer atolls, has also been an SOE perpetually in crisis and requiring significant subsidies and capital injections. Under new management, services have been improving, but tariffs need reform and CSOs need to be identified to allow the airline to operate commercially.
- Recent increases in subsidies to Tobolar, the coconut-processing plant, to support low-income outer-island communities have risen to crisis levels and threaten financial stability. From a level of $1.3 million three years ago subsidies are projected to reach $12 million in FY2019, or 6 percent of GDP. After the coming November 2019 elections, there will be an urgent need to revisit the most appropriate means and level of outer-island income support.

5. State-Owned-Enterprise Reform

A. Sector Overview and Reforms

SOE overview: The SOE sector, comprising a dozen public enterprises, continues to underperform and to impose significant risks and burdens on the fiscal system and economy. Table 12 provides a set of summary financial measures of the SOE sector and figure 29 a graphical presentation. As a whole, the sector made an average operating loss of $6.0 million over the FY2016–FY2018 period and incurred average subsidies of $13.1 million. Capital transfers to finance fixed-asset levels required to maintain operations were also significant, averaging $10.2 million. Rates of return on assets and on equity were −4 percent and −6 percent, respectively, indicating the very poor performance and return on government's investments. At the start of the amended Compact period, rates of return on assets and equity over the FY2003–FY2005 period were −6 and −12 percent, respectively. Thus, it might be argued there has been some improvement. However, rates of return remain well into negative territory. Current subsidies during the last three years now represent an average of 18 percent of general-fund revenues. Including capital transfers, the number rises to an average of 32 percent. Once merely an important financial issue, the RMI government's level of subsidy to the SOEs is now approaching seven times its external-debt service, placing a special burden on maintaining fiscal balance and indicating the urgent need for reform.

SOEs performing poorly: In 2010 and 2011, the ADB[1] undertook two studies on SOEs: one in the RMI and the other as part of a regional study. Both highlight significant and sobering weaknesses in the RMI's SOE governance and policy regimes. The reports revealed weak SOE oversight and accountability, which have allowed continued poor performance on the part of the vast majority of the enterprises. Both reports strongly emphasize the need for reform. As stated in the 2010 review, "Transferring significant public resources to weakly performing public enterprises without any strong accountability requirements has sent a very clear message: performance really does not matter."

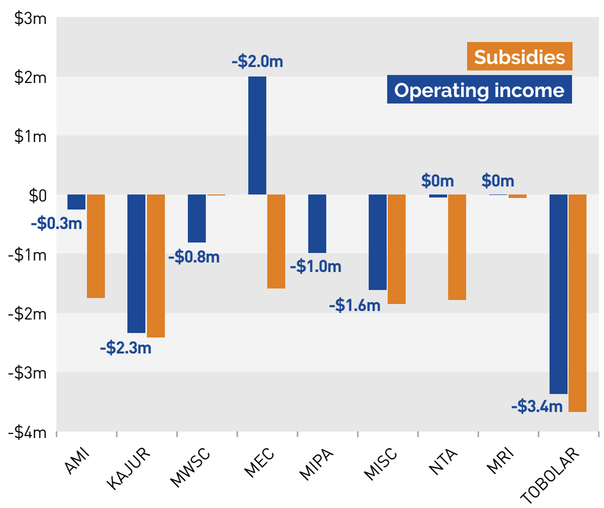
New SOE legislation with ADB support: With technical support from the ADB, a new SOE bill was drafted and adopted by the cabinet in late 2011 and finally passed into law in 2015.

1 ADB, Review of Public Enterprises and Options for Reform, 2010; Finding Balance, 2011.

Table 12 SOE financial performance, averages FY2016–FY2018

SOE	Operating income	Current subsidies	Capital transfers	Total assets	Total liabilities	Equity	Rate of return "on assets"	Rate of return "on equity"
AMI	-252	1,743	544	11,079	5,888	5,191	-2%	-5%
KAJUR	-2,337	2,416	2,002	6,669	3,978	2,691	-35%	-87%
MWSC	-810	10	508	2,429	2,537	-108	-33%	752%
MEC	1,997	1,588	224	25,207	19,429	5,778	8%	~
MIDB								
MIPA	-986	0	3,519	71,383	2,133	69,250	-1%	-1%
MISC	-1,609	1,846	0	4,255	794	3,460	-38%	-46%
NTA	-42	1,776	0	29,471	24,279	5,192	0%	-1%
MRI	4	50	2,436	1,887	1,430	456	0%	1%
Tobolar	-3,369	3,678	0	2,265	2,059	206	-149%	-1634%
Total	**-5,794**	**13,106**	**10,225**	**154,644**	**62,526**	**92,117**	**-4%**	**-6%**

Figure 29
State-owned enterprises, subsidies and net operating profit, average FY2016–FY2018



The major elements of the law included the following:

- **Primary objective**: (i) Have SOEs be successful businesses and as profitable as comparable enterprises, and (ii) maximize the net worth of the SOEs.
- **Statement of corporate intent**: a statement of corporate objectives and how these align with the primary objective to be prepared annually; a strategy to achieve commercial viability and identify targets to monitor and assess performance; a description of any CSOs and the impact on commercial viability. The statement of corporate intent must be submitted to the minister by the start of the financial year and in turn the minister is required to submit to the Nitijela within 15 days
- **Business plan**, to be prepared annually, to contain information on the operations and strategic direction with financial projections sufficient to assess whether the SOE will achieve the primary objectives. Each SOE must develop a business plan before the start of each financial years and submit to the minister after board approval.
- **Community-service obligations**: The minister responsible for SOEs (the minister of finance) may issue CSOs for SOEs to provide specific services. The CSO must specify the goods and services with quantities for delivery, including costs, revenues and subsidies, and specify how performance in providing CSOs is to be monitored and assessed.
- **Governance**: Minister of finance appoints board directors and chairman, who must be qualified to support the SOE in attaining the primary objective. Directors are not permitted to be public officials, but one may be appointed within the first three years of execution of the act. A series of other good-governance requirements are included in the law.
- **Reporting**: Annual financial and audit reports are required, together with a more detailed annual report, which must specify CSOs.

The law provides a sound framework for SOE management and should if implemented lead to an improvement in SOE performance. Considerable power has been vested with the minister of finance, a move that has been criticized for concentrating too much control with one minister to regulate SOE operations and appoint board members. However, the alternative—to decentralize the law among the ministers directly responsible—could well lose the commercial focus of the reform. Given the critical nature of SOE reform to the RMI, a possible solution might be to create a special ministry with experience in business and commercial operations to oversee the reforms and implementation of the law.

Law amended to allow minister to appoint public officials: Subsequent to the passage of the law, an amendment was passed to permit the minister of finance to appoint with cabinet approval a maximum of three qualified public officials, including ministers, to SOE boards. The amendment was justified on the basis of the limited number of potentially qualified directors in the RMI but came under criticism for increasing the potential for political interference in SOE management. It is certainly true there is a limited talent pool to draw on. However, the change in law would seem to be directly opposed to the primary objective of commercial operation and noninterference in SOE management. This is a disappointing development in what otherwise appears to be a sound piece of legislation.

The SOEMU has now been set up in the Ministry of Finance as part of the ADB PFM effort. This will provide a critical component to assist the effective implementation of the law, providing transparency and public accountability. Coupled with an advisor funded under the ADB TA, a new assistant secretary was appointed to manage the unit in mid-2019. During the current year, the SOEMU has made progress, with 9 out of 11 SOEs preparing a business plan and statement of corporate intent for submission to the minister and Nitijela. While some of the SOEs did not meet the deadline, considerable progress has nevertheless been achieved. The current focus during the coming year will be for SOEs to prepare reports and make an assessment against the business plans. Only once assessment against performance measures defined in the plans is thoroughly evaluated can the system be said to be accountable.

CSOs: CSOs define services to be delivered to government on a contractual basis, but they are expected to take time to develop. In 2019 two entities, AMI and Tobolar, made efforts to develop CSOs, but these were not achieved in time for the FY2020 budget. In some cases, where current subsidies are provided for specific services, such as Jaluit and Wotje power generation, this should not prove difficult. But in others, subsidies have been provided to cover losses of the enterprise without regard for specific services, where effectively the whole enterprise operates inefficiently. Transforming these enterprises to operate commercially will be far more challenging.

SOEMU making good progress despite capacity limitations: Establishing the SOEMU with qualified staff on a sustainable basis will, however, not be easy. The SOE sector is large, and the nascent unit is small and inexperienced. Noting the limited capacity currently existing in the Ministry of Finance to execute basic accounting functions and controls, establishing the new unit will take time. While the law provides an important framework for SOE management, success of the reforms will lie with the effectiveness of implementation. From a slow start the unit is picking up momentum and making good progress and fulfillment of its mandate.

B. SOE Performance

THE MARSHALLS ENERGY COMPANY

The Comprehensive Recovery and Business Plans: The MEC's reforms have been guided by the Comprehensive Recovery Plan (CRP), prepared in 2010, which identified major reform goals, objectives and actions and has been the guiding light for policy. The CRP sets out a number of reforms covering MEC governance, policy, performance and finances. The ADB PSP loan also included MEC policy actions and requirements. In fulfillment of the requirements of the SOE legislation, the MEC has prepared a business plan covering the 2020–22 period and a statement of corporate intent. These documents supplant the prior CRP.

MEC needs to implement a full-cost-recovery tariff: The original MEC tariff template was adopted in 2005, but in 2011 a new tariff was adopted that has brought the costs and revenues of its electricity business into closer alignment. However, tariffs were not set to achieve full cost recovery but rather to achieve cash flow balance. In 2014 kilowatt charges per unit were reduced from 43¢ to 34¢, reflecting the reductions in international oil prices. However, the reductions in fuel prices were not fully passed on to consumers, permitting the MEC to improve its financial position. In 2018 the ADB conducted a financial-management assessment of the MEC.[2] The study found that the "MEC's tariff policy is opaque and not based on an assessment of MEC's costs or revenue requirement. . . . In other words, MEC's true costs are not precisely known, nor reflected in its budgeting, estimates of its revenue requirement, or end-user tariffs." Unfortunately, the study did not include development of a new tariff structure that would enable the MEC to operate on a commercial basis. Development of a full-cost-recovery tariff thus remains a key need if the entity is to fulfill the requirements of the SOE Act and to operate on an economically efficient basis.

Improvements at MEC: The retirement of the MEC's commercial debt with the Bank of Guam in early 2011 (facilitated by the ADB PSP loan)

2 ADB, Energy Security Project (FFP RMI 49450-011)-Financial Management Assessment, Manila, 2018.

freed up cash flow for the company. The RUS awarded a $2.3 million competitive grant to refurbish one of the two main Deutz generators. However, the need remains to refurbish the second. The MEC has rolled out a set of prepay meters, and 90–95 percent of customers have been converted. The plan is to extend the program to commercial and government customers, but it requires three-phase meters, which need to be identified. The MEC has also retrofitted all Majuro public streetlights to more-efficient LED lights, which should reduce its nonrevenue generation ratio.

System losses: The MEC's system losses, the difference between generation and sales, remain high, currently estimated to be between 28 and 29 percent. Efficient utilities operators would target system losses in the range of 9–14 percent. Generation losses, the use of power in generation itself, are estimated to be 8–10 percent (target level of 5 percent), with distribution loss making up the remainder of system losses. The MEC has set itself a target system loss of 20 percent overall. The ADB is financing an advanced metering study to identify where system losses occur—that is, where power is consumed but not billed.

Donor assistance: A large number of grant-funded energy donor projects have been approved or are under consideration for the RMI, totaling close to $85 million. The EU has approved close to $10 million for energy renewables, generation, transmission and distribution losses. The World Bank has approved $34 million for renewable-energy projects, promotion of energy efficiency, and TA. The ADB has also approved close to $34 million for a variety of energy projects. Bilateral donors JICA and New Zealand have further committed $10 and $1 million, respectively. Loans have also been approved, but these are unlikely to be drawn on since they violate the World Bank's grant-only designation. Many of these projects will partner with the MEC with an emphasis on reducing reliance on costly fossil fuels and increasing efficiency in production and distribution.

MEC turns profit in generation for the first time in FY2016: As shown in table 13, the MEC has made significant financial progress during the last four years, registering its first profit in FY2014 and attaining an operating income of $4.4 and $2.0 million in FY2016 and FY2017, respectively. FY2016 was the first time the utility recorded a profit from generation, reflecting the reduction

Table 13 Marshalls Energy Company indicators, FY2007–FY2017

	FY10	FY11	FY12	FY13 (c)	FY14	FY15	FY16	FY17	FY18
Utility operations indicators									
Utility operating revenues (a)	15.0	18.0	18.7	19.7	19.4	16.4	17.1	17.9	18.3
Utility operating expenses	17.9	20.3	20.9	21.6	21.5	17.5	14.4	17.1	18.4
Net operating income (loss) from utility operations	-2.9	-2.2	-2.2	-1.9	-2.0	-1.1	2.7	0.8	-0.1
Non-utility operations indicators									
Non-utility revenues (fuel, propane, lubricants, other)	19.8	27.3	31.4	31.1	31.8	20.5	12.0	13.2	16.0
Non-utility expenses	18.5	25.8	29.6	29.4	29.7	18.4	10.3	12.0	16.1
Net operating income (loss) from non-utility operations	1.3	1.5	1.8	1.7	2.1	2.1	1.7	1.2	-0.1
Total net operating income (loss)	-1.7	-0.8	-0.5	-0.2	0.1	1.0	4.4	2.0	-0.2
Other indicators	0.0								
Transfers (current subsidies)	0.9	0.9	1.6	1.1	0.7	0.6	2.6	1.1	1.2
Cash ratio (cash to current liabilities)	5%	3%	5%	8%	4%	4%	8%	28%	40%
Accounts receivable (b)	3.8	6.7	7.1	7.5	8.8	6.4	6.0	7.1	6.1

(a) Net of provision for doubtful accounts.
(b) Net of allowance for uncollectable accounts.
(c) FY2013 figures adjusted for $2.4 million of "offset" booked as revenue.

in fuel costs, which was internalized and not passed through to consumers. The MEC also turned a profit on generation in FY2017 but at a reduced level because of rising fuel costs. These trends continued in FY2018, and the utility once again recorded an operating deficit. Its nonutility business, and in particular its diesel-fuel-sale business, which has been the lifeline of the company, has seen reduced profitability in FY2016 through FY2018. In part, this reflects bunkering of purse-seine vessels on the high seas.

Cash flow weaknesses: While performance has improved, the MEC remains in a precarious situation, especially with regard to its cash flow and short-term solvency position. As shown in table 13, the MEC's cash ratio (the amount of cash on hand relative to current liabilities) remains at a low level, despite recent improvements. Specifically, the MEC had an average of only 6¢ on hand for every $1 owed of current liabilities (due within one year) during the FY2008–FY2016 period. In FY2018 the quick ratio improved to 40 percent, an improved performance. As shown in the table, current subsidies to the MEC were $1.2 million in FY2018, reflecting CSOs of $0.6 million to support operations in Wotje and Jaluit and $0.6 million to fund maintenance of solar units in the outer islands.

Large accounts receivable: The MEC also continues to have problems with collections. Accounts receivable remain very high, reaching $15.3 million in FY2018, of which $9.2 million is considered as uncollectable and some $8.9 million is due from related SOEs and government agencies, with $3.8 million due from the private sector. Net accounts receivable represents some 34 percent of revenues from generation, clearly an untenable situation for a company already strapped for cash. Conversion to prepay meters has provided some relief, but more-aggressive collection practices are necessary to further reduce the level of receivables. Payments due from other SOEs—KAJUR, the MWSC and the Marshall Islands Resort—are particular offenders. The strategy has been for the MEC to default on its tax payments to government, and every few years an offset is agreed whereby the MEC is forgiven its debt to government in exchange for forgiveness to related parties. This practice is inefficient and hides the real level of subsidy to the other SOEs.

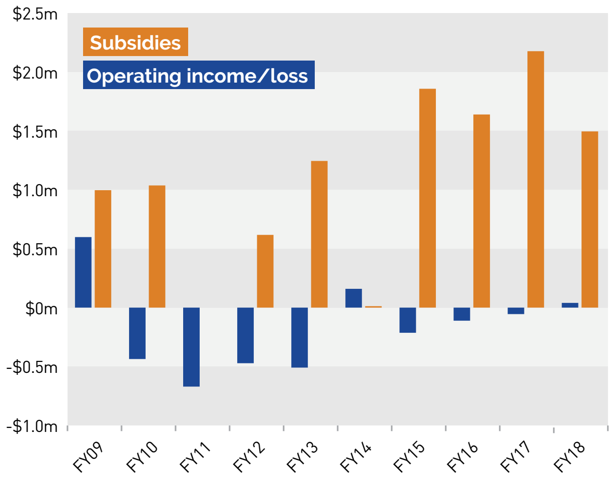
Potential for commercial viability: In summary, while the MEC has made tangible progress in several areas, its financial position remains generally insolvent, with tariffs set below full cost recovery. With a new tariff allowing the MEC to operate on a commercial basis, commitment to implementing the reforms outlined in the CRP and a new business plan, and continued donor support, the MEC could become an example of a well-managed SOE.

NATIONAL TELECOMMUNICATIONS AUTHORITY AND WORLD BANK ICT REFORMS

Fiber optic connection pushes NTA into deficit: In FY2009 the RMI installed a submarine fiber optic cable linking Majuro to Guam. This venture was funded by extending the existing RUS loan of $12 million by an additional $18 million (total outstanding debt of $19.7 million to the RUS at the end of FY2018). At the time of commitment to extend the RUS loan for the fiber optic project, it was understood that the NTA would require subsidy to cover the additional debt-service obligations, documented in the cabinet minutes. However, fulfillment of this understanding in a regularized fashion was not forthcoming. For an entity already operating on a tight cash flow basis in FY2008—before the installation of the new fiber optic cable—the increased debt-servicing costs without subsidy pushed the NTA into a financial crisis, and the NTA defaulted on its loan obligations.

Government fails to pay debt service on fiber, and the NTA defaults: During most of the 2000s, the NTA was the only SOE that recorded consistent operating profits. However, in FY2010 it recorded its first operating loss, which was $0.4 million (see figure 30). This was followed by continuing losses in most years through FY2018. In FY2009 it received its first subsidy, which was to continue through FY2018, although erratically in both timing and amount (support in FY2011 was provided through loan finance). Since the government has not made good on the subsidy in the regular and sufficient amounts committed to in the original cabinet understanding, NTA policy has been to honor the debt-service commitment to the RUS on existing debt but to default on the fiber optic component. Thus, the government has no alternative but to live up to

Figure 30
National Telecom Authority, subsidies and operating loss, FY2009–FY2018



its obligations in order to avoid NTA default. As in the case of the MEC, the lack of transparency and fulfillment of obligations by the government has encouraged a strategic response from the SOE sector, which is inefficient and not in accord with principles of best practice.

World Bank ICT reforms: In early 2013 the government initiated a shake-up of the management of the NTA, revamped the board of directors and appointed a new general manager. These moves were conducted at the same time that the government was considering a World Bank initiative to liberalize the RMI telecommunications sector and to open the NTA to competition. The World Bank program proposed a series of grants totaling $13 million of budgetary support in return for liberalizing the telecommunications sector. Of the initial tranche of $3 million of unconditioned budgetary support, the funds were used to support the operations of AMI, the MEC and the Marshall Islands Resort, but none were directly used in the ICT sector. To qualify for the funds, the government was required to

- adopt a new ICT policy,
- draft new telecommunications legislation to introduce to the Nitijela and
- publicly advertise the ongoing developments.

Reforms meet resistance: However, acceptance of the benefits of the reforms was not widespread. While support was forthcoming from the Ministry of Finance, there was opposition from other quarters, including the incumbent telecom provider, the NTA. While the principles of an open ICT market and competition are not disputed, the World Bank failed to provide any indication of the market structure following reform or transition costs that might be expected from new competition in the cellular-network market, particularly in a small market such as the RMI. In the absence of a well-prepared transition plan and analysis of potential fiscal implications for the government, the reforms lacked credibility and failed to gather momentum, despite the carrot of $10 million more in unconditioned budgetary support.

New World Bank study initiated to assess options for reform: After a period of inactivity, funds left unused from the TA to support the reforms have been reprogrammed to a new, more limited objective: to assess and improve ICT-sector structure and performance, including undertaking a financial assessment of the NTA, a market analysis and an options assessment. The final report[3] has now been completed by the consultants. The report outlines three options:

- NTA "business as usual"
- RMI selects a private operator to provide retail services
- Private management contract

Business as usual is not recommended: The business-as-usual option is analyzed and indicates that the NTA suffers from a wide range of service-delivery inefficiencies and financial weakness. The essentially bankrupt nature of the NTA will inhibit access to the capital and investment necessary to address the poor quality of service. Over time, this will worsen, and government will be required to continue the costly subsidies. Further, the failure to provide modern standards of services will negatively impact economic growth, frustrate introduction of eGovernment, limit the role of IT in the education system and hinder the rolling out of

3 Great Village International Consultants, ICT Sector Analysis & NTA Readiness Assessment; Draft Final Report Telecommunications Sector Options & Roadmap, Great, Toronto, 2019.

health-information systems. Business as usual is not recommended.

Privatization of retail services and assets the preferred option: The solution proposed by the Great Village International Consultants (GVIC) report is for the retail side of the NTA's operations to be privatized. It is not envisaged that the market would initially attract more than one operator, but rather a license would be issued for a limited period to a sole provider. The consultants recognize the danger that a private sector monopoly might result in a worse outcome than a public one. However, market "contestability" in the medium term and provision of strong regulation and monitoring should prevent this outcome. While NTA retail services would be privatized, the wholesale side of the business and in particular the existing Hantru fiber connection to Guam would be established as a separate entity, known as the Special Purpose Vehicle (SPV). This would operate at cost and provide access to the network to any interested service provider.[4]

SPV to acquire wholesale assets and debt refinancing with provision of donor-funded investment: The GVIC report proposes that donor funding and support would underpin the privatization process. The existing wholesale assets and RUS debt would be transferred to the SPV. By the estimated date of the privatization, the RUS debt amounting $16.4 million would be refinanced on more favorable terms with $5 million paid down through donor funding. This would maintain the solvency of the SPV balance sheet, with assets approximating the outstanding level of liabilities and debt. Donor funding would further fund $5 million in infrastructure for provision of fiber to the premises and outer-island improvements. GVIC anticipates that privatization would bring in a further $12–$15 million of private investment. Total donor funding anticipated is $18 million.

Management contract not recommended: GVIC also analyzes contracting out NTA to a private provider for a five-year period but does not recommend this option. It is unlikely to generate the additional private or donor funding or bring about the improvements in service required.

Privatization appears an attractive option but does not come without cost or risk: Given the financial status of the NTA, access to capital to improve ICT, under the business-as-usual plan, is largely nonexistent. While the privatization option seems attractive, there are risks. Clearly, market regulation of a high quality is required to ensure that the sole provider does not abuse its market position. A well-managed privatization would clearly lead to benefits and better services that otherwise are likely to stagnate at best. GVIC projects that, as a result of provision of better ICT services, GDP could rise by up to 6 percent. However, there are also drawbacks: there would be significant job loss of up to 50 percent of current staffing levels, which could be funded through favorable redundancy packages but would carry a significant political cost. GVIC presented its report in February 2019, but as yet no decision has been made, although it is understood the proposal is being considered favorably.

AIR MARSHALL ISLANDS

AMI has run major operational losses throughout the amended Compact totaling $15.1 million. These shortfalls have necessitated continued government operating subsidies and capital transfers, amounting to $15.5 and $9.3 million respectively. Performance has improved during the last few years, with the company close to breaking even, although operational losses increased in FY2018 largely because of the need to finance major maintenance needs of one of the aircraft. In FY2018 AMI received subsidies from government of $1.4 million, of which $1.29 million was for aircraft overhaul and parts and the remainder for operations. As a result of the improved management and maintenance, passenger departures grew by 27 percent in FY2018.

Operational issues: The airline operates three planes: a Dash 8 and two Dornier 228s, one of which was added to the fleet in 2015 and financed through a government capital transfer. In FY2013 the Dash 8 underwent major repairs and maintenance in Australia that were financed through a $2.5 million loan from the MIDB. Again

4 This provision is similar to that existing in the FSM and Palau, where an "Open Access Provider" pro vides access on a level playing field to private operators.

in 2018 the aircraft underwent major repairs (C-check), this time costing $1.9 million. However, the aircraft suffers from low utilization because of lack of adequate minimum-equipment list and spare parts. Poor runway conditions in the outer atolls place heavy maintenance needs on the aircrafts and hinder efficient operations. It is understood the outer-atoll runways are not eligible for FAA or Compact grants, but in recent budgets the government has allocated funds for resurfacing and improvements. The tariff guide that specifies fares and cargo charges was approved in 2011 by the cabinet but has remained unchanged and allows for no changes in fuel or operational costs.

AMI develops a business plan: In 2013 a business plan was prepared for the airline, with the objective to operate on a commercial basis, financed from internally generated resources. The plan indicated that for a company with negative equity of $0.8 million, accumulated losses of $7.8 million and liabilities of $8.5 million, this posed a significant challenge. The business plan proposed six objectives but was not endorsed by the cabinet. In 2015 a new general manager and chief financial officer were recruited to improve the viability of the company, and a redrafted business plan for 2016–18 was prepared and approved. Of the original six objectives, focus has been placed on (i) repairing outer-island airstrips, (ii) reversing losses and (iii) renewing operations.

Compliance with the 2015 SOE Act: With the need to come into compliance with the new SOE Act, AMI has taken the lead in preparing a statement of corporate intent and a new business plan for FY2020–FY2022. The former objectives have been refocused from aspirational goals into more specific management processes:

- *Aircraft maintenance*: Improve maintenance and parts inventory to develop plans and models to enhance operations.
- *Aircraft scheduling*: Improve aircraft deployment in scheduling and routing based on operational and cost analysis.
- *Administrative efficiency*: Improve operational systems and management-information systems to enhance decision making and operational efficiency.
- *Operating skills*: Invest in skills for aircraft flight crews, engineering and other specialist skills for Marshallese persons.
- *Existing business management*: Manage budgets and targets to effectively and efficiently as possible continue serving existing customers.

CSOs yet to be developed: While AMI has fulfilled the initial requirements of the SOE Act, it has yet to develop CSO contracts for unprofitable but eligible elements of its business for funding by government. Both the SCI and business plan list the development of CSOs as a future activity without going into detail. Clearly, definition of CSOs will require careful financial analysis of operations before quantifiable targets and government support can be defined. However, for a corporation whose business is largely based in provision of services to the outer islands and communities of the Marshall Islands, commercial or even profitable operation cannot be achieved without incorporation of CSOs into the core business model.

AMI has been in crisis for decades: While the balance sheet has improved under new management, AMI continues operating at a loss, although losses have fallen in the last few years. Running an airline in an environment such as the Marshall Islands with CSOs to service the outer-atoll communities is clearly no easy task. Other airlines in the Pacific region have achieved these objectives, and there is no reason the Marshall Islands should not be able to do so as well. However, moving from an inefficient, dependent operation to a commercially viable one under the new SOE law will require clearly defined CSOs, ability to set tariffs on profitable routes, financial restructuring and adoption of modern and efficient business practices. The management has outlined a way forward in its recent business plans and statement of corporate intent, but there remains a long road ahead.

KWAJALEIN ATOLL JOINT UTILITY RESOURCES

KAJUR operating losses financed from Compact grants: KAJUR, which provides power, water and sanitation services on Ebeye, ran operating losses of $2.3 million in FY2017 and

$3.6 million in FY2018, respectively. Operating subsidies to KAJUR provided from Compact funding in these years totaled $4.5 and $1.3 million, with capital subsidies of $3.2 and $2.8 million, respectively. Over the amended Compact, KAJUR has received $32 million in operating subsidies and $10 million in capital grants. The utility is governed and managed by the RMI Combined Utility Board of Directors, which includes the MEC. The MEC also provides fuel on credit to KAJUR, with an outstanding payable of $4.9 million to MEC at the end of FY2018. KAJUR is the most heavily subsidized and financially insolvent member of the RMI's SOEs.

Major donor projects are being executed to improve the provision of utilities in Ebeye: While water and sanitation services are provided free to the residents of Ebeye, government and the private sector pay commercial rates. Electricity is sold at "affordable rates" and well below full cost recovery. A US Army Corps of Engineers survey in 2010 documented major problems in KAJUR's core operating systems. Since 2008 KAJUR has made significant investments in new generators, which have in turn stabilized the power supply on Ebeye. Nonetheless, KAJUR's system losses remain significant, and its water and sewer systems and services remain very poor. A major project, the Ebeye Water Supply and Sanitation Project (EWSSP), is being funded through a cofinanced DOI, ADB and Australian Agency for International Development (AusAid) infrastructure project ($19 million) and due for completion in 2021. The EWSSP is designed to improve access to safe water and sanitation and promote behavioral change to improve hygiene standards. In addition, the Ebeye Solar Project was agreed to with JICA in 2017 with $10 million of funding for the installation of solar electricity generation, which is scheduled to be bid out in 2019.

MAJURO WATER AND SEWER COMPANY

MWSC receives hidden subsidies: Like most SOEs, the MWSC ran operational losses: $0.8 and $0.9 million in FY2017 and FY2018, respectively. The last tariff study was 12 years ago, and the MWSC operates well below full cost recovery. However, unlike most other SOEs, the MWSC does not currently receive significant subsidies from government. However, this hides a large unpaid liability to the MEC of $2.6 and $2.8 million in FY2017 and FY2018, respectively; in effect, the MWSC fails to pay its electricity bills. Periodically, the government undertakes an "offset" in which all cross-liabilities between government-related parties and SOEs are cleared. There is thus a hidden subsidy equivalent to the unpaid electricity bills.

ADB water-and-sewer project for Majuro: The MWSC conducted a 20-year development plan, which guides operations and investments. A tariff study is planned together with preparation of an SCI and business plan as required under the SOE Act. A Majuro water-and-sanitation project entailing $6 million of investments was identified in the development plan, is under consideration by the ADB, and is in the bank's pipeline of projects.

THE MARSHALL ISLANDS SHIPPING CORPORATION

Continuing need for subsidy: The MISC has significantly improved the reliability of shipping services, compared to the previous service run by the Ministry of Transport and Communications' Sea Transport Division. However, the MISC operates below full cost recovery and requires continuing subsidy from the government. In FY2017 and FY2018, the MISC ran operating losses of $1.2 and $2.1 million, requiring subsidies of $1.9 and $1.9 million (close to 60 percent of operating costs) in the two years, respectively. Over the amended Compact, the MISC has received a total of $17 million in operating subsidies. As in the case of the MWSC, although to a lesser extent, the MISC has a significant liability, or accounts payable, to the Marshall Islands Ports Authority and the Marshall Islands Social Security Administration because of lack of cash flow.

MISC operates four vessels, with more planned: The MISC operates a fleet of four boats, with new vessels financed by Japan commencing operation in FY2014. In 2011 the government passed the Shipping Vessel Repairs and Maintenance Act, which provides for subsidy to maintain the fleet in safe operating order. However, despite the passage of the law, the MWSC failed to receive the maintenance subsidy in FY2014, although it recommenced in the following year. In 2019 the MISC expects to take receipt of a further vessel.

Tariffs unchanged since 1983: The tariffs in operation were set by the Nitijela in 1983 and are today well below full cost recovery. The board of the MISC has repeatedly asked the government to raise tariffs to improve efficiency in operations, but the government has failed to approve. Implementation of the SOE Act and adoption of a primary objective to operate on a commercial basis and where appropriate to receive government subsidy for defined CSOs would considerably improve the efficiency of operations.

TOBOLAR

Large increases in subsidy: The Tobolar Copra Processing Plant has run operating losses averaging \$1.6 million during the amended Compact and received subsidies from the government averaging \$1.7 million, totaling \$15 million during the same period. This makes Tobolar the second-largest recipient of operating subsidies in the RMI. Operating income is variable, depending on coconut-oil prices. In FY2011, an exceptional year, a profit of \$1.1 million was achieved, reflecting low production and high prices. However, this was exceptional, and since then the situation has reversed, as prices reverted to lower, more normal levels, and Tobolar has recorded an annual average loss of \$2.7 million. In FY2016 subsidies of \$3.4 million were recorded; they rose to \$4.5 million in FY2018, a considerable increase over former levels, which averaged \$1.4 million in the FY2010–FY2015 period.

Increase in producer price to 50¢ per pound for copra necessitates unprecedented increase in subsidy: At the end of 2017, government increased the subsidy paid to Tobolar from 30¢ to 50¢ per pound, incurring an estimated increase in subsidies for FY2018 from \$3 to \$6 million. Only \$4.5 million was transferred, but in order to meet payments to growers Tobolar largely exhausted its cash reserves, which fell by \$0.8 million during the year. The increase in price that was originally intended as a Christmas bonus continued through 2018 and into 2019, an election year, and led to a reported grower-supply response that increased the need for support. A budgeted amount of \$5.2 million was allocated for FY2019, but by midyear this had been exhausted and required top-up from a loan from the MIDB of a further \$6 million.

Need for adoption of reform in income support to outer-island communities: The copra subsidy has provided an important means of income support targeting low-income farmers in the outer islands. Former studies of the practice have, however, characterized it as highly inefficient and unsustainable. Clearly, the increase in the subsidy has reached crisis levels, and, if maintained, it will absorb a significant proportion of the large increase in sovereign rents. The time has come for careful analysis and evaluation of the current practices with the objective of establishing more effective and efficient transfer mechanisms. Hopefully after the November 2019 election such a course of action might be pursued and a more sanguine and sustainable policy implemented.

6. The Financial Sector

Commercial bank lending in the RMI is more active than in the Micronesian sister states of the FSM and Palau. The RMI achieved a loans-to-deposit ratio of 56 percent (FSM 22 percent, Palau 13 percent). However, the inability of businesses to prepare meaningful business plans and financial statements, lack of collateral, and the limited ability to use land as security have inhibited financial intermediation.

- A particular issue for the RMI has been the worldwide phenomenon of "de-risking" by international financial institutions. In order to reduce exposure to money-laundering and financing of terrorism and to avoid stiff penalties imposed by regulatory authorities, international banks are reducing their exposure through limiting correspondent-banking relationships (CBR).
- A major pressing fiscal issue facing the RMI has been the potential collapse of the SS system. In an effort to avoid collapse, the Nitijela enacted legislation in 2017 to reform both the contribution and benefit streams. However, while extending the life of the system, the reforms are likely to delay rather than avoid eventual fund collapse. The government initially committed to contributing $3 million to SS, but in the FY2020 budget the appropriation was reduced to $1.7 million. The lower level, if sustained, will accelerate fund collapse.
- In March 2018 the RMI declared its intent to issue a digital currency—to be known as the SOV—based on blockchain technology. The SOV is to act as legal currency in the RMI in addition to the US dollar.
- The passage of the law to issue the SOV as legal tender resulted in widespread interest and concern from international institutions. The most recent IMF Article IV consultation in 2018 and staff visit in 2019 advised the RMI to not adopt the SOV.
- Many risks concerning the issue of the SOV have been identified, with macroeconomic stability and anonymity of transactions being two of the major concerns. The facilitation that cryptocurrencies afford to money laundering and financing of terrorism (AML and CFT) is a particular issue.

6. The Financial Sector

A. Money and Banking

The limitations of monetary policy in the RMI: With the adoption of US currency in the RMI, macroeconomic policy and adjustment has been limited to fiscal policy. The use of a foreign currency is practiced in many other small island economies of the Pacific and has served the RMI well. While the range of macroeconomic policy options is limited, the use of US currency has removed the potential to use inflationary monetary policy to adjust to changes and reductions in Compact funding. Consequently, the RMI has no means of adjustment to reduced levels of resource transfers other than the more politically painful policy of directly cutting government expenditures, reducing public sector employment and wages, and increasing domestic revenues. Furthermore, the use of a foreign currency has removed exchange rate realignment to encourage the export and traded-goods sectors of the economy. At this stage of economic development in the RMI, with many underlying structural impediments, exchange rate adjustment without accompanying supporting policies would be unlikely to have encouraged a favorable supply response in traded-goods production.

Bank regulation: The banking system in the RMI is regulated by the banking commissioner, whose role includes the licensing of domestic and foreign banks, on- and off-site supervision of all commercial banks, and consumer protection. The MIDB does not currently come under the regulatory inspection of the banking commissioner. Until December 2002, when the Bank of Hawaii withdrew from the market, two US banks were operating in the RMI. The remaining US bank, the Bank of Guam, is a branch of its parent registered in the United States, comes under US federal supervisory requirements and is insured by the FDIC. There is one locally owned bank, BOMI. Although the financial system has provided satisfactory and secure banking services, the marketplace, because of its small size and lack of a well-developed supervisory capability, requires careful monitoring.

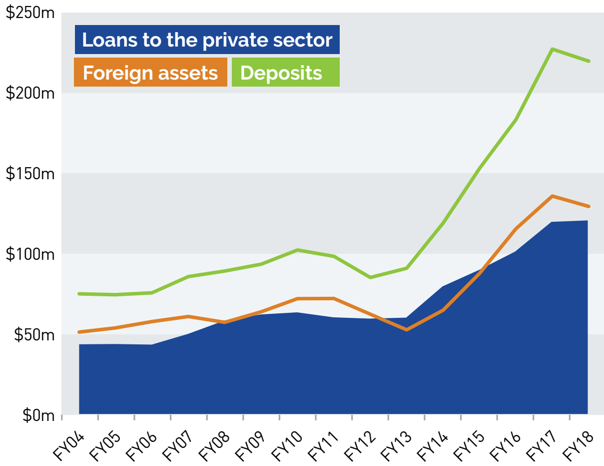
De-risking and correspondent banking: A critical issue facing the commercial banking sector and financial stability of the RMI is the possible loss in financial services provided by international banks (referred to as global “de-risking”). To reduce exposure to money laundering and to reduce noncompliance with regulation, global banks are reducing correspondent-banking services to third-country banks. In the case of the RMI, BOMI is threatened by the potential withdrawal of these services provided by the United States, which would result in a serious loss of financial stability. Moves supported through the IMF—capacity building and strengthening of the Banking Commission—are under way to avert this outcome. The existing provider of corresponding-banking services in the United States indicated its intention to withdraw but continues to support BOMI on the understanding that the bank continue to improve its AML and CFT activities. A long-term solution has yet to found, and the recent decision by the government to issue a cryptocurrency (featured below) has provided further uncertainty.

Deposit interest rates reflect US rates, but lending rates reflect risk in the local market: Since there is no independent monetary policy, domestic deposit interest rates are closely aligned with those in the United States. During the amended Compact, deposit rates have been low, with average effective rates recording 1.4 percent in FY2018. Lending rates, however, are generally higher, reflecting the additional risk, costs of doing business in the RMI and limited competition. Average effective interest rates on consumer loans were 12.1 percent in FY2018. Lending rates for commercial borrowing are significantly lower than unsecured consumer rates. In FY2018 the average rate was 6.8 percent. As in many developing countries, financial intermediation is accompanied by a significant spread between lending and deposit rates.

The deposit base has grown rapidly in recent years: Major trends in lending and deposits in the RMI banking sector during the amended Compact are shown in figure 31. On the deposit side, the first three years of the amended Compact saw little movement. However, growth emerged in FY2007, and deposits grew by 8 percent per annum in the FY2006–FY2010 period. The deposit base contracted in FY2011 and fell significantly in FY2012, by 3.8 and 13.4 percent, respectively, reflecting the payout of $29 million in rent owed to Kwajalein landowners. After several years of dispute with the United States, the landowners came to an agreement and a large backlog of prior years' Compact transfers was released. Part of the payment was used to finance consumption, and some was used to pay down existing debt. In FY2014, after the impact of the Kwajalein landowner payout had worked its way through the system, the deposit base resumed its upward trend, growing by a very significant annual average of 26 percent over the FY2013–FY2017 period.

Deposits fall in FY2018, probably reflecting drawing down of MIMRA reserve deposits: In FY2018 the strong upward trend in deposits came to a halt and fell by 3 percent. The official statistics indicate that this occurred in private sector checking accounts. However, FY2018 was a good year for the economy, and there is no evidence to suggest any reduction in business confidence. Rather, discussion with

Figure 31
Commercial bank loans and deposits
(end of period)



the banking commission suggests this may reflect the rundown of former MIMRA deposits to support the rapid fiscal expansion. If this is so, it suggests care needs to be taken in the classification of deposits so that monitoring of the financial sector can reflect the true underlying forces at work.

On the lending side, a similar picture emerges: Commercial bank credit was stagnant at the start of the amended Compact, but it expanded between FY2006 and FY2010 at an annual average rate of 10 percent and then dropped back in FY2011 and FY2012 by 5 and 1 percent, respectively. Again, as the impact of the Kwajalein landowner payout had worked its way through the system, domestic credit grew by an annual average of 19 percent between FY2013 and FY2017. During the last year, FY2018, bank lending stagnated, growing by 1 percent.

Loans-to-deposit ratio, while low, is high by regional standards: Reflecting the trends described above, the loans-to-deposit ratio grew steadily during the amended Compact through FY2014, attaining a level of 74 percent. However, despite the continuing growth in credit, the ratio subsequently dropped back to 56 percent in FY2018, reflecting the rapid growth in deposits. The commercial lending market is considerably more active in the RMI than in the sister economies of the FSM and Palau, where the loans-to-deposit ratios in FY2018 were 22 and 13 percent, respectively. The significant difference between the markets has both positive and negative aspects. It is positive in the sense that the banking sector is considerably more proactive in the RMI. However, it could become a matter for concern if banks were to lend aggressively and the deposit base was to contract further and precipitate a liquidity crisis.

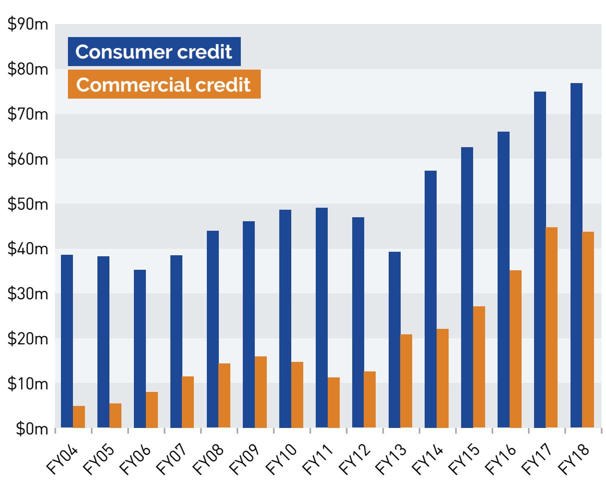
Foreign assets rise rapidly in recent years, reflecting deposit growth, but drop back in FY2018: The difference between the level of deposits and loans is invested offshore, and, mirroring the trends in deposits and domestic credit, the level of foreign assets rose from $51 million in FY2004 to $72 million in FY2011, an annual average growth rate of 5 percent. After declining in FY2012 and FY2013, reflecting the runoff in deposits with the Kwajalein landowner payout, the level of foreign assets rose strongly by an annual average of 27 percent to $136 million in FY2017 with the rapid buildup in deposits. In

FY2018, with the contraction in deposits, the level of foreign assets also fell by 5 percent.

High level of consumer credit: Figure 32 indicates the extension of credit to the private sector in the consumer and commercial markets during the amended Compact period. At the start of the period, lending opportunities for consumer credit declined. However, they generated an upward trend from FY2006, growing by an annual average rate of 7 percent through FY2011, before dropping back in FY2012 and FY2013 as landowners repaid debt. Consumer lending resumed its upward trend in FY2014, growing by an average of 14 percent through FY2018. A point of concern in the RMI has been the high level of household indebtedness. Lending as a percentage of total compensation of employees is very high in the RMI and has grown from a rate of 40 percent in FY2006 to 60 percent in FY2018. Deducting payments for taxes, SS and health insurance, the ratio to household disposable income is even higher. While there may be some misclassification of consumer loans that may, in fact, be for business purposes, the figures indicate a high level of household indebtedness, which not only will place stress on household finances but also poses a threat to the banking system.

Commercial credit has grown in recent years, but the level of financial intermediation in the RMI economy is weak: While extension of credit to the consumer market has been the backbone of the banking business, lending to the commercial sector remains at relatively low levels, reflecting the many impediments to lending. Insufficient collateral and weak business practices, such as inability to maintain financial statements or prepare business plans, reduces the attractiveness of the private sector as a source of viable lending opportunities to the commercial banks. At the start of the amended Compact, lending to the commercial sector stood at a meager $5 million, or 4 percent of monetary GDP. This rose through FY2009 to $16 million but in the subsequent three years dropped off, reflecting paying down of debt out of the Kwajalein landowner settlement. In FY2013 commercial lending bounced back strongly, adding $8 million in credit, or 66 percent, in just one year. In the following years through FY2018, commercial credit has continued to expand, and in FY2018 it represented 22 percent of monetary GDP, which despite the recent improvements indicates a low level of financial intermediation.

Figure 32
Commercial bank credit by sector



B. Social Security Sustainability

SS system projected to be unsustainable: The 2011 actuarial[1] report prepared for the Social Security Administration on the status of the SS investment fund and on options to improve long-term sustainability indicated that

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

Status of SS indicates a funded ratio of 16 percent: Table 14 indicates the status of the valuation of the fund conducted for 2011, 2014[2]

1 Pacific Actuarial Services, Republic of the Marshall Islands Social Security System, Proposed Plan Design Study, Liberty, MO, 2012.

2 Wilshire Associates, Inc.; Republic of the Marshall Islands Social Security System Actuarial Valuation as of October 1, 2014; California, USA, 2016.

Table 14 Social security valuation during 2011, 2014 and 2017 (US$ millions)

	2011	2014	2017
Present value of future benefits	287.3 (1)	484.8	463.0
Present value of future expected contributions		-113.8	-120.9
Market value of assets	-65.0	-72.4	-72.7
Unfunded present value of future benefits	222.3	298.6	269.3
Funded %	23%	15%	16%

Note 1: Total accrued actuarial liability

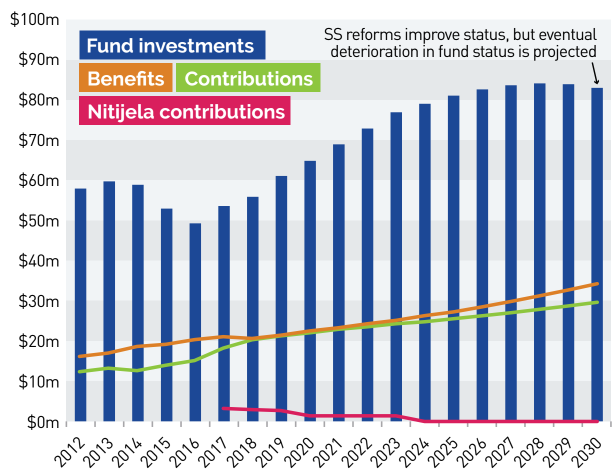
and 2017.[3] As of October 1, 2017, the present value of future benefits amounts to $463 million, while that of future expected contributions is $121 million, in comparison to a market value of investments of $72 million. The fund thus has an unfunded liability of $269 million and a funded ratio of 16 percent, a low percentage.

Proposed reform bill number 43: In 2013, given the projected demise of the SS system, a bill, number 43, proposed a series of reforms to amend the system to attain long-term sustainability. The legislative reforms proposed four basic changes to the system: increases in the tax rate from 7 to 9 percent, an increase in the retirement age from 60 to 65, an extension of the quarterly-earnings limit from $5,000 to $7,500, and a reduction in benefits of 22 percent. On projecting the reforms,[4] the impact of any of the proposed changes on its own was shown to fail to achieve sustainability—that is, the fund was projected to continue to decline and to collapse at some future point. However, combining all the reforms in the legislation would have a powerful overall impact, and the fund would achieve sustainability in the long term.

Reforms enacted: In any event, Bill No. 43 was not acted on, but the issue was subsequently taken up again, in late 2016. A new bill was drafted and became law, PL 2017-30. The reforms under the new law were to (i) increase the cap on taxable incomes to $10,000 per quarter, (ii) increase the taxable rate from 7 to 8 percent, (iii) reduce benefits by an average of 5 percent, and (iv) increase the retirement age gradually to 65 in increments to become fully in effect by FY2025. While the eventual law contained many of the original elements of Bill No. 43, the depth of the reforms fell short of the original, and therefore they are projected to be insufficient to avoid eventual fund collapse.

Divergence between contributions and benefits: Figure 33 indicates the impact on the SS system of the reforms contained in PL 2017-30, based on the benefit projections of the 2011 actuarial study. In FY2018, the first year of the reforms, the benefit and contribution curves are brought closer into alignment, and balance is nearly achieved. However, from this point forward a growing divergence is noted. As a result of the reforms, the contribution curve shifts upward but growth is slow, reflecting a weakly growing economy (projections based on chapter 9 of this review). The benefit curve,

Figure 33
Impact of PL 2017-30 Social Security Reforms, FY2012–FY2030



3 Wilshire Associates, Inc.; Republic of the Marshall Islands Social Security System Actuarial Valuation as of October 1, 2017; California, USA, 2018.

4 Projections of contributions have been made based on the projected level of wages and salaries estimated in the long-term-projections chapter of this review. Projections of SS benefits have utilized the 2011 actuarial study. The projections of the corpus are based on the 2018 level and assume a 6.5 percent return.

however, continues its upward momentum and diverges from contributions.

Nitijela subsidizes SS to maintain sustainability: In FY2017 the Nitijela contributed $3 million to the SS Fund, and a further contribution of $3 million was made in FY2018. In the FY2019 and FY2020 budgets, further contributions of $2.3 and $1.4 million were programmed, respectively. Continuing contributions of $1.4 million have been assumed to continue through FY2023 to the end of the amended Compact. As a result, the fund continues to grow through FY2028 but starts to decline from that point onward, with eventual fund collapse projected beyond the time horizon considered here. Clearly, the reforms of PL 2017-30 and the additional contributions from the Nitijela have made a significant contribution to the sustainability of the SS system. However, at some point it may be necessary to revisit the issue and consider whether further reforms are necessary. In the absence of structural reforms, government will need to continue annual budgetary support after FY2023.

Experience study completed, and updated actuarial study under way: It is important to note that the basis of the benefit projections was the 2011 actuarial assessment, which is now considerably out of date. Since that time, an "experience" study has been conducted that will replace the prior assumptions with Marshallese data, which formerly relied on US life tables. An updated actuarial study drawing on the experience study is underway, and once the results are known and the projection curves re-estimated, it will be possible to redraw the projections provided in this review.

C. Cryptocurrency

RMI declares issuance of digital currency as legal tender: In March 2018 the RMI declared its intent to issue a digital currency, based on blockchain technology, to be known as the SOV. The SOV is to act as legal currency in the RMI in addition to the US dollar. An "appointed organizer," selected by the cabinet, is to take responsibility for the initial currency offering (ICO) and for development of the blockchain technology and software to transact in the currency in the RMI. An initial 24 million SOVs will be issued, half of which will be held by the RMI government and the remainder owned by the organizer. The minister of finance is to be responsible for regulation of the SOV, and the banking commissioner will be responsible for compliance with standard Know Your Customer (KYC) procedures.

While benefits might be large, risks both known and unknown may be far greater: The passage of the law to issue the SOV as legal tender resulted in a widespread interest and concern from international institutions. While there are many cryptocurrencies in existence, none have been issued as legal tender by a sovereign state. Many central banks have examined the potential to issue a digital currency to the public, backed by the currency in circulation, but so far, they have been cautious about issuing their own digital currencies. The RMI proposal thus represents an effort not specifically attempted before. While the potential gains from sale of the SOV could be large, many risks have been identified. Anonymity of transactions has been one of the major concerns, especially the facilitation that cryptos afford to money laundering and financing of terrorism. The RMI proposes to remedy this concern through the KYC provisions in the law. However, it is not clear how these would be maintained in jurisdictions outside the RMI or after the ICO. Clearly, since anonymity is one of the major attractions of cryptos, the absence of this provision would limit its uptake.

Issuance of SOV threatens correspondent-banking relationship with First Hawaiian and may undermine macroeconomic stability: Another concern has been the risk to the CBR relationship of BOMI with First Hawaiian Bank. Clearly, money-laundering and financing-of-terrorism risks associated with cryptocurrencies may adversely affect BOMI's CBR with First Hawaiian or other international banks or hamper BOMI's establishing of its own facilities in the United States. It is also not clear what the position of the FDIC might be in relationship to the other bank in the RMI, the Bank of Guam, in terms of accepting and holding SOVs on the balance sheet. A further issue is volatility in the value of cryptos, which have displayed high levels of price volatility. Should the SOV be taken up actively within the RMI, this could prove highly destabilizing and disrupt orderly payments. While having the SOV be widely used as a basis for transactions in the RMI may not have been the intention in the design of the system, the SOV is being issued as legal tender.

RMI not to proceed until AML and CTF issues have been resolved: IMF recommends against issuance of SOV: The government's current position, which has emerged since the enactment of the legislation, is that the RMI will not proceed with coin issuance until this has received approval from US authorities. Selection of an "appointed organizer" will be delayed for a two- to three-year period while independent expert advice is sought and resolution of the many risks that have been identified has been found. As a part of the 2018 IMF Article IV consultation to the RMI, a special study on the SOV was undertaken.[5] The reader is referred to this report for additional information and assessment of the financial and economic implications of the issuance of the SOV. The IMF concludes that "considering the significant risks and challenges, staff recommends that the authorities seriously reconsider the issuance of the SOV as legal tender."

5 IMF, Republic of the Marshall Islands: Selected Issues, IMF Country Report No. 18/271, Washington, DC, 2018.

7. Private Sector Development

The World Bank's Doing Business Survey paints a discouraging view of the environment for private sector development. Out of 190 countries, the RMI currently ranks 150th, 78 percent down the list, indicating that there is much room for improvement.

- Participation in the PNA, a cartel of nine Pacific Island states that allocate rights for "fishing days," has become an important component of the RMI economy. Since the introduction of the VDS, there has been a remarkable increase in member-country revenues. The RMI received over $26 million of revenues from this one source in FY2018.
- An emerging concern for the PNA region is the operation of the FSM Arrangement. FSMa was set up to encourage domestic fishing production. However, issue of licenses under the FSMA, frequently to companies that provide little more local value added than their establishing of local offices, incurs considerable potential loss of royalties.
- An issue that has attracted considerable interest is the operation of the corporate- and shipping-registry services provided to the RMI by the Trust Company of the Marshall Islands (TCMI), a wholly owned subsidiary of a US company, International Registries.
- There is a general lack of factual information and transparency on the operations of the TCMI. There is no publicly available financial information to indicate whether the RMI receives a fair share of the earnings. There is thus a need for a transparent evaluation, particularly when there is perceived unfairness and loss of royalties to the RMI.

7. Private Sector Development

A. The World Bank's Doing Business Survey

RMI scores poorly on World Bank's Doing Business Survey: The World Bank's *Doing Business Survey* provides a general assessment of the environment for private sector development. Table 15 indicates the RMI's rankings for each of the 10 major categories, which indicate a deteriorating rank relative to the other countries surveyed. While little action has been taken over the period regarding the business environment, the declining score suggests that other nations have actively pursued reforms. Overall, the RMI currently ranks 150th out of a total of 190 countries, over 75 percent down the list, suggesting there is much room for improvement. The RMI fares better than one Micronesian neighbor, the FSM, which ranks 155th, but not as well as Palau, ranked 130th. In the South Pacific, Papua New Guinea is ranked 108th, Fiji 101st, Vanuatu 94th, Tonga 91th and Samoa 90th. Overall, the RMI's scores are weak. Registering property ranks 187th—not quite at the bottom of all countries surveyed by the World Bank—while for protecting investors, the RMI also ranks close to the bottom, with a ranking of 180th. Resolving insolvency is also poor at 167th. The RMI registers its best rank, 73rd, for dealing with construction permits.

B. Regulatory Framework[1]

Introduction of secure-transactions registry proves successful: Secure-transactions legislation was introduced into the RMI in 2007. It enables individuals and businesses to use moveable property, but not land, as security for a loan, and it provides a simplified means of reprocessing assets in the event of default. The system is maintained in an online registry and reduces risk to lenders through providing a fast and inexpensive means to assess what chattels have been pledged as security and register new interests. The system has proven a success with banks in the RMI, with an average of 1,500 new registrations each year. The use of the registry is one of the highest in the region and outperforms other Micronesian nations such as Palau, where there has been a slow growth in utilization of the facility.

1 This section draws heavily on Private Sector Assessment, Pacific Private Sector Development Initiative (PSDI), Sydney, Australia. PSDI is a regional technical-assistance facility cofinanced by the ADB, the government of Australia, and the New Zealand government.

Table 15 RMI: ease of doing business, World Bank ranking

Marshall Islands	2012	2013	2014	2015	2016	2017	2018
Ease of doing business overall rank	106	101	139	140	143	149	150
Starting a business	52	48	70	71	70	72	75
Dealing with construction permits	8	4	10	63	79	71	73
Getting electricity	76	73	68	125	126	126	132
Registering property	183	185	189	189	187	187	187
Getting credit	78	83	71	79	82	90	90
Protecting investors	155	158	183	178	175	177	180
Paying taxes	96	92	128	125	82	83	70
Trading across borders	66	65	68	75	64	67	75
Enforcing contracts	63	66	58	65	99	99	103
Resolving insolvency	135	140	168	167	167	167	167

Business registration is inefficient and slow: Business registration serves important commercial obligations by enabling businesses to locate each other and to settle financial claims and by providing public information on business identity. Registration involves three core procedures: establishing the uniqueness of the business name, entering the name in the registry and registering with the tax authorities. If an economy is to provide an enabling commercial environment, it is important the process be transparent, fast and inexpensive. In the RMI, company registration is regulated through the Business Corporations Act, and the attorney general's (AG's) office acts as the registrar. While the legislation follows modern practice, it is inefficient, relying on manual procedures for completing and submitting paper documents. Approval can take up to a month and is dependent on staff availability in the AG's office. Many countries have introduced online systems with standard forms and procedures to enable swift and legally sound procedures. While the process requires establishing IT capacity to maintain the process, costs can be reduced through possibly including foreign-investment permitting and business licensing. The process could also be contracted out to a private entity to develop and maintain the database.

RMI lacks business-licensing law, while local governments issue licenses that lack transparency: Business licensing regulates business-enterprise entry and conduct in markets. The principal purpose is to define a number of specified sectors in which licensing is required to safeguard public interest or manage limited natural resources rather than as a means of taxation or to restrict market entry and competition. It is particularly important in resources-based sectors or economies in which resources are limited or subject to environmental damage such as the Pacific Islands region. The RMI government lacks a business-licensing law, although local governments have the authority to issue business licenses under the Local Government Tax and Fees Act. The system is used as a means of revenue raising rather than legitimate licensing, and it lacks transparency, as it grants permission to the mayor to refuse issuance. Absence of a well-formulated legislative framework leads to uncertainty and unpredictability and is likely to inhibit market entry or expansion. Under a reformed licensing regime suited to the purpose, the system could be piggy-backed onto the business-registration process. However, the revenue implications and needs of local government would need addressing, perhaps as part of any tax-reform process. The issue of revenue sharing between the national and local governments was a particular concern during the previous tax-reform initiative.

FDI regime revised in 2005 to simplify process but remains complex and time consuming: FDI is regulated in the RMI under the Foreign Investment Licensing Act, which is administered by the taxation division of the Ministry of Finance. The law was revised in 2005 to simplify the process, but it does not appear to have achieved this objective or restricted FDI from entering the list of reserved activities. The restricted list includes small-scale agriculture and mariculture enterprises, bakeries, motor garages and fuel filling stations, taxis, car rentals, small retailers with less than $1,000 quarterly turnover, laundromats, tailors, video-rental businesses, delis and food take-out shops. The foreign-investment business-licensing process is conducted manually and takes weeks to months to complete. Businesses are required to complete all business registration and licensing procedures, register for SS, and secure resident permits before issue of license. Under modern FDI-licensing regimes designed to facilitate FDI, businesses are only required to provide government with information required for statistical and aftercare purposes. Licenses are then issued within a matter of days, and other regulatory requirements are then fulfilled subsequently just as required of any domestic investor.

Current law is not monitored or enforced and is in need of modernization: Under the current regime, even short-term consultants are required to obtain a foreign-investment business license, which, in an environment of limited skills, inhibits business activity. Further, there is ambiguity over the application of the law. Once a foreign-investment business license is issued, there is currently no active monitoring to ensure investor compliance and there is a lack of information on the number of foreign investors operating. Recent follow-up activity by the Office of Commerce and Investments suggests there is a lack of compliance, with businesses operating in areas in which they have not been approved and are on the restricted list. There is a clear need to review the whole FDI regime if the RMI wishes to take advantage of foreign investment and accelerate economic growth. Modern procedures need to be developed that issue licenses automatically in a couple of days to investors outside the restricted list.

Currently 400–500 foreign workers in the RMI, but work permitting is in need of streamlining and simplification: The labor market remains limited in the RMI, and foreign workers are used in a range of skills from entry-level jobs to those requiring advanced qualifications and experience. In total, there are between 400 and 500 foreign workers in the RMI, of whom about 75 percent are believed to be skilled. No database of work-permit holders is maintained, and thus the precise numbers or skills of foreign workers are unknown. Businesses requiring foreign workers must go through a two-part process: applications for a work permit from the Labor Division, and an entry visa from the Immigration Division. The legislation was reformed in 2006, but there is confusion over the order of application and the process is slow and cumbersome. The government is considering combining the two divisions into a single entity, which should help make the process more efficient. As part of the 2006 reforms, a special category of permit for skilled workers was created to facilitate the entry process through creating the Occupational Shortage List. Jobs falling under this category would not require advertisement and be subject to the normal 30-day wait period. Unfortunately, the Occupational Shortage List has yet to be developed.

Bankruptcy is overly complex and outdated and needs reform: As indicated in the World Bank's *Doing Business Survey*, the RMI fares particularly badly in the area of resolving insolvency. Bankruptcy laws play an important role in a modern economy by allowing businesses to settle their debts and start over. They further enable financial institutions and banks to foreclose on failing businesses and retrieve part if not all of the outstanding credit advanced. The RMI's existing bankruptcy framework is overly complex and outdated and needs to be replaced by modern bankruptcy law.

The RMI land-tenure system is complex, and security of tenure requires strengthening: Clearly defined landownership and security of title is a critical component of economic development. In the RMI, as in many other Pacific Islands economies, land is largely owned by customary groups with complex governance structures. Banks are reluctant to take as collateral customary land either owned or leased. Non-Marshallese are not allowed to own land, and even transactions between Marshallese are rare. A key objective of economic development is to improve tenure security for both landowners and leaseholders by accurately defining and protecting land rights. In 2004, with ADB support, the Land Recording and Registration Act was introduced as a voluntary means for customary landowners to register land and develop an accessible registry of land transactions. The Land Registration Authority (LRA) was introduced to implement the new legislation. However, the uptake in use of the LRA has been minimal, and currently only seven land parcels have been registered and 35 title applications lodged.

Establishment of the LRA, while well conceived, has not been widely taken up: This has in part been due to the limited dialogue on the benefits of the system and the perception that the process was externally driven. The LRA was initially provided authority to make decisions regarding landownership claims, but the body lacked legitimacy with customary landowners and the power was withdrawn. Disputes must now be resolved through traditional methods and the court system, which are time consuming and costly. However, the 2004 legislation and the LRA are generally considered to provide a sound basis for loan administration in the RMI. The process of improving public awareness with both government and private sector backing needs reinitiating so that secure registration and leasing of land can support its critical role in business and financial development.

C. Privatization

Early efforts to privatize failed: As part of the reforms specified in the 1997 ADB PSRP, the shipping services provided by the Ministry of

Transport and Communications' Sea Transport Division were privatized and the construction and maintenance functions of the Ministry of Works were contracted to the private sector. However, both functions were brought back into the public sector after the closeout of the PSRP. In the case of domestic shipping, an SOE was created by law in 2004: the MISC. The PSRP saw the creation of the Private Sector Unit (PSU) to oversee the privatizations and rationalization of the SOE sector. In many senses, the PSU was very similar in function to the currently created SOEMU in the Ministry of Finance. The original PSU was not intended as a permanent feature of government, but, clearly, monitoring, providing support in defining CSOs for SOEs, and performing other regulatory functions requires the creation of a permanent body. The failure of the PSU and the PSRP in this regard was in enacting reforms through legislation without the capacity or human resources to implement them. Privatization requires a public partner with sufficient capacity to support and manage the process and monitor it thereafter.

Possible privatization opportunities exist, but considerable groundwork is required: The recent Private Sector Assessment[2] proposes the possible privatization of air services and cites experience in South Pacific nations (the Cook Islands and Tonga) where domestic flight operations to geographically dispersed islands are successfully provided by the private sector without government support or subsidy. It is clear there are numerous potential candidates for greater private sector involvement in the RMI, including the original privatization of shipping services, contracting out the construction and maintenance operations of public works, and privatization of AMI as proposed in the PSA, to name a few. However, to be successful, such endeavors require political commitment, something that has been conspicuously absent. An SOEMU, a clearly defined set of contractually bound CSOs between government and the SOE, and regulatory support with sufficient human capacity are all necessary conditions. The recent successes of the SOEMU and issuance of statements of corporate intent and business plans are a first step. Development of CSOs is to follow, and if successfully implemented it could provide an environment to attract private investment.

2 Ibid.

D. Corporate and Shipping Registry

Corporate and shipping registry of the RMI is operated by a private entity, but operations are clouded by a lack of transparency: An issue that has attracted considerable interest is the corporate- and shipping-registry services provided to the RMI by the TCMI, a wholly owned subsidiary of a US company, International Registries. The registry provides services for nonresident corporate-registration and shipping services. Under the terms of the Compact, vessels registered in the Marshall Islands are treated as if they are US–registered vessels and benefit from the defense rights of the Compact and US protection on the high seas. As a result, many large US shipping companies use the Marshall Islands for registering their ships. At the start of the amended Compact, the RMI government received $1 million from the registry, which rose to $7.3 million in FY2017. There has been a general lack of information and transparency on the operations of the TCMI. As a result, there is a perception that the RMI has not received a fair deal from the Trust Company and that there are large hidden rents waiting to be harvested.

A recent article in the Marshall Islands Journal provides some indication of the operations of the TCMI.[3] The article indicates that the TCMI had total revenues of $64 million in 2014, with costs of $55 million, and realized a profit of $5 million after payment of $4 million to the RMI government. These figures compare reasonably with estimates based on the total tonnage registered in the RMI and based on known volumes of companies' registry and average registration fees. On the surface, the apparent 50 percent share in profits paid to government would not seem unreasonable. However, further details on costs revealed in the Marshall Islands Journal indicate a very high level of salaries, some $27 million, or close to 50 percent of total operating costs. Whether

3 "Audits Attest to Registry's Value," Marshall Islands Journal, September 1, 2017.

this figure includes salaries of the corporation's principals and thus "hidden" profits is not possible to assess.

Need for independent study of the ship and corporate registry: In the FSM, establishing a domicile for Japanese captive insurance and large corporations has been undertaken on a transparent basis, with the FSM receiving 60 percent of proceeds. In the RMI, an open and transparent assessment of the registry needs to be undertaken to evaluate whether the RMI receives a fair share of the proceeds. Alternatively, a competitive bidding process could be initiated to ensure the RMI receives its fair share of the sovereign rent attributable to the activity. It is understood that the government is currently reviewing the situation as the current contract comes up for renewal in 2020.

E. Fisheries and the Domestic Fleet

The fisheries industry in the RMI comprises provision of shore facilities to skipjack-tuna purse-seine operators, a home base for longline sashimi-grade operations, a fish-loining plant, and a variety of small domestic fishing activities. The contribution to the economy has grown significantly during the amended Compact period from $7.5 million in constant prices at the start to $15.5 million in FY2018. Total fish licensing has grown, and associated fees collected by the MIMRA have also grown, from $3.5 million in FY2010 to $32.2 million in FY2018. Much of the increase has been in the last five years because of the implementation of the VDS of the PNA. The PNA is a cartel of nine Pacific Island states that, because of the introduction of the VDS, has led to a remarkable increase in member-country revenues. Daily fishing rates to third-party foreign fishing vessels currently average over $11,000 and $12,000 per vessel-day, and the RMI received over $28.8 million of revenues from this one source in FY2018.

FSM Arrangement to encourage domestic fisheries development may lead to large loss in revenues: A particular concern for the PNA region is the operation of the FSM Arrangement (FSMa). The FSMa was established to encourage the development of domestic fishing fleets and to permit access to fishing resources of other parties' fleets. Fishing operators are accorded domestic fishing-fleet status under the FSMa and pay a reduced daily rate, in the vicinity of $7,000 per day. The issue concerns whether the reduced fishing fee and loss in revenue is offset by increases in benefits to the PNA economies. In the RMI case, the Koos fishing company operates four purse seiners and a further boat under a joint equity venture with the government. Pan Pacific operates five boats and the loining plant at significant recorded loss to capture the rent from the reduced domestic fee rate.

Early results from Graduate School USA study indicate $500 per day economic benefit from the FSMa, suggesting a significant loss to the RMI economy: Preliminary results from an ongoing study of the fisheries sector by the Graduate School USA suggest the additional benefits to the RMI from domestic vessels compared with bilateral vessels is close to $500 per day. This means discounts to domestic vessels that exceed $500 per day may cause substantial economic losses. However, estimating the costs and benefits is complicated by the need for domestically flagged vessels to pay transfer fees to other participant FSMa members when fish are caught in their waters. The analysis also needs to include estimates for inbound transfers from other-country FSMa vessels fishing in the RMI waters. The preliminary results from the Graduate School study suggest it is most probable the RMI would have incurred significant losses through participation in the FSMa scheme. Arrangements such as that adopted in PNG in which discounts are provided in proportion to demonstrated and proven benefits may provide a more economically efficient method to encourage development of the domestic fishing industry. For 2019, the RMI has increased the fees paid by domestic vessels, thus reducing the gap between the FSMa and foreign-vessel prices and reducing potential economic loss.

8. The Compact Trust Fund

The estimated value of the CTF at the end of FY2018 was $402 million, including a large $45 million increase in FY2018 reflecting favorable market returns of 14.1 percent. During the investment period since the outset of FY2006, the CTF has achieved an annualized rate of return of 6.68 percent.

- Assuming the pledged contributions from Taiwan continue and in the absence of market risk and volatility, the CTF would only need to grow at 4.6 percent annually from FY2018 to FY2023 to achieve a level sufficient to provide a smooth transition to CTF distributions from FY2024 onward at the real value of FY2023 sector grants ($26.65 million).
- In the presence of market volatility, the Graduate School has modeled outcomes under the CTF distribution rules. The model results for the RMI indicate a significant probability of periodic fiscal shocks, including years in which zero dollars are legally available for distribution.
- Recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost.
- The Graduate School study identifies a rule, called SAFER, requiring a CTF corpus 1.67 times the estimated size based on market returns without risk or volatility. Attainment of SAFER without further contributions would require an annual rate of return of 15.9 percent.
- Making substantial improvements to the terms of the CTF Agreement would require mutual agreement by the original parties, which for the United States entails both executive and congressional approval.

8. The Compact Trust Fund

A. Performance of the Compact Trust Fund (FY2004–FY2018 and projected to FY2023)

BACKGROUND

United States indicates no guarantee of distribution level after FY2023: The establishment of the trust fund for the people of the RMI (CTF) was a major feature of the amended Compact. The trust fund was created, according to the preface of the CTF Agreement, "to contribute to the long-term budgetary self-reliance of the RMI . . . [and] to provide the Government of the RMI with an ongoing source of revenue after FY2023." The design features of the trust fund related to distributions to the RMI from FY2024 and thereafter are specified in the CTF Agreement, Articles 16(7) (a) and (b). The explicit linkage of distributions and the fully inflation-adjusted value of the Compact annual grant assistance provided in FY2023 has the potential to create expectations that such levels of support from the CTF may be forthcoming. However, the US government has made it clear that neither the terms of the amended Compact nor the terms of the CTF Agreement make any guarantee, or even a commitment, that the trust fund will be able to sustainably achieve distributions of any specific size.

GAO bases analysis on inflated FY2023 assistance levels: Still, even the US Government Accountability Office (GAO) in its June 2007 report[1] and subsequent May 2018 report[2] completed its analysis based on the assumption that distributions would equal the above-described (maximum) level. When challenged on that assumption with the fact that such levels of disbursement are neither required nor guaranteed, the GAO countered that "[it] believe[s] it is appropriate to undertake a projection of the likely disbursements against that benchmark."[3] The GAO also noted that "[it] believe[s] that careful analysis of the trust funds each year will help establish realistic expectations."[4]

Basis of Graduate School analysis: This chapter is prepared in fulfillment of our general terms of reference to describe key economic trends and describe policy options for consideration by our readers, especially RMI leaders and officials from the United States and the RMI engaged in Compact management. Given the immense importance of the CTF to the RMI's long-term prospects for achieving economic self-reliance, our review provides an analytical perspective in addition to that provided through the published reports of the RMI CTF Committee, the US GAO and the ADB. The authors use the maximum level of distribution to complete probability-based (stochastic) projections for the period after FY2023, while noting fully the risk of falling short and the need for RMI leaders to continue to strengthen their policy focus on alternative measures to mitigate the risk of potential periodic (or even sustained) fiscal shocks.

Immense and repeated fiscal shocks projected: As noted in previous Graduate School USA annual economic reviews, the CTF Agreement includes certain technical characteristics likely to become problematic during the distribution period. It is inarguable that the best interest of all parties would be served if, over the long term, the real value of the CTF was protected and robust mechanisms ensured the relative stability of annual distributions from the CTF to the RMI. Unfortunately, as currently specified, and in the absence of stellar investment-return rates or

1 GAO-07-513, "Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income," June 2007, http://www.gao.gov/cgi-bin/getrpt/GAO-07-513.

2 GAO-08-415, "Compacts of Free Association: Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income," May 2018, http://www.gao.gov/cgi-bin/getrpt/GAO-08-415.

3 GAO-07-513, appendix V, p. 56.

4 Ibid, appendix V, p. 56.

large additional contributions over the remaining accumulation period through FY2023, the real value of the CTF corpus has an unacceptably high likelihood (29 percent probability) of declining over the course of the distribution period; perhaps more urgently, the stability of annual distributions will be at risk. Immense and repeated fiscal shocks are more likely to arise because of the specific characteristics agreed to by the parties and enacted in US law. The result is, again, an unacceptably high likelihood (56 percent probability) of at least one fiscal year in which a zero distribution would be allowed under prevailing rules. While amending these provisions is no easy task—especially since US congressional approval is required—the RMI CTF Committee, in collaboration with the JEMFAC and with the US and RMI governments, may wish to consider (a) modifying problematic design characteristics of the buffer-account mechanism; (b) modifying a distribution mechanism that results in timing that conflicts with the prevailing practice of estimating annual allocation decisions each January and confirming them each August in advance of the subject fiscal year; and (c) devising distribution rules that could better protect the real value of the corpus over the long run while also reducing the volatility of distribution levels and reducing the frequency of shortfalls in annual fiscal support to the RMI. Ideally, the adopted distribution policy will also include mechanisms to automatically manage tail risks inherent to market-based returns on both the downside (through gradual distribution compression) and the upside (through gradual distribution venting).

PERFORMANCE MONITORING

Graduate School projects $27.12 million target distribution in FY2024: This subsection presents a CTF simple sufficiency estimate and related analysis. That estimate is defined as the size the CTF would need to achieve by the end of FY2023 to support a smooth and sustainable transition from US-appropriated annual sector grants to fully inflation-adjusted annual CTF distributions to the RMI. The simple sufficiency estimate is updated to reflect actual outcomes to date, particularly with respect to the partial inflation adjustment that has been applied through the FY2020 budget estimates and with respect to projected inflation going forward. Future inflation projections are linked to US Congressional Budget Office published projections through FY2025. Using these assumptions, the level of Compact sector grants in FY2023 is projected at $35.76 million. Of this, $26.65 million is scheduled to terminate after FY2023, with the remaining $9.11 million scheduled to continue to flow via sector grants dedicated to Kwajalein-based activities. With full projected inflation (at 2.09 percent) for FY2024, the $26.65 million is adjusted upward to $27.12 million. That portion of the grants that does not continue is used in this review to estimate the simple sufficiency estimate.

Market assumptions: The Graduate School assumes that the RMI CTF investment strategy at that time would need to provide for a prudent balance of risk while allowing for long-term growth. From FY2024 onward, and for estimation purposes only, a balanced investment allocation is assumed, as detailed in the following section. Over a 93-year period, the real rate of return using econometric estimation techniques is 5.0 percent. Thus, if inflation were to average 2 percent, a nominal rate of return of 7 percent is implied. Dividing the $27.21 million (maximum) distribution by a 5.0 percent real rate of return yields a simple sufficiency target of $544 million.

Projected CTF in FY2023 exceeds simple sufficiency level: Using the above-detailed assumptions and starting with the end-of-FY2018 RMI CTF value of $402,436,422, the rate of return required to achieve the simple sufficiency estimate for the RMI CTF of $544 million would be just 1.34 percent annually for the five remaining years from FY2019 to FY2023. This assumes planned contributions from the United States and the ROC, the subsequent contributor, are fulfilled. Such a rate of growth is more likely than not; however, a slight risk remains of a less favorable outcome. Using probability analysis, the median projected level of the RMI CTF at the end of FY2023 is $664 million, or 122 percent of the simple sufficiency estimate. In the same modeling process, 81 percent of the cases resulted in an FY2023 balance equal to or greater than the simple sufficiency target of $544 million.

Projected return on CTF approximates actual to-date returns: To put those forward projections into perspective, the long-term projected rate of return of 7.0 percent in nominal terms modestly exceeds the rate of return experienced by the RMI CTF during the period it has been invested, FY2006–FY2018. The experienced asset-weighted rate of return from FY2006 through FY2018 was 6.68 percent. The asset-weighted rate of return from initial funding on June 1, 2004, through the end of FY2017 is 6.51 percent, reflecting the delay in getting the CTF established and fully invested at the outset of the amended Compact period.

D account is an important supplemental fund: The RMI has funded the D account within the CTF mechanism. As of the end of FY2018, the value of that account was $16.0 million, or just over 4 percent of the size of the RMI CTF (A plus C accounts) at that date. To the extent the RMI fulfills some of its ongoing commitments or emerging plans and makes additional contributions to the D account or a separate fund dedicated to the goal of post-FY2023 fiscal sustainability, it could develop an important supplemental funding source to mitigate periodic or sustained fiscal shocks.

Need to mobilize additional resources: Consistent with recommendations in recent CTF annual reports, joint or unilateral efforts to mobilize additional contributions—from domestic and external sources—to the CTF would improve the RMI's long-term fiscal stability and economic security. Similarly, the RMI government's cabinet-considered long-term fiscal strategy includes commitments to develop prudent and promising expenditure and revenue policies that take into account the risks faced after FY2023.

Favorable CTF corpus value does not eliminate risk: It should be noted that achieving a CTF size that matches or narrowly exceeds the simple sufficiency estimate does not, by any means, eliminate the risk going forward of subsequent severe and repeated fiscal shocks. Periodic strong performance of the CTF does not eliminate the urgency to consider opportunities to achieve mutual agreement on a distribution policy or amendments to enhance the CTF Agreement. In the following section, a more sophisticated, risk-inclusive form of analysis is presented to analyze the range of outcomes that might prevail given the volatility of market returns and the uncertainty of the sequence of those returns over time. That analysis defines the SAFER alternative, which, in effect, requires a larger fund balance than the "simple sustainability" estimate. As shown in figure 34, that estimate is for a fund size of $907 million.

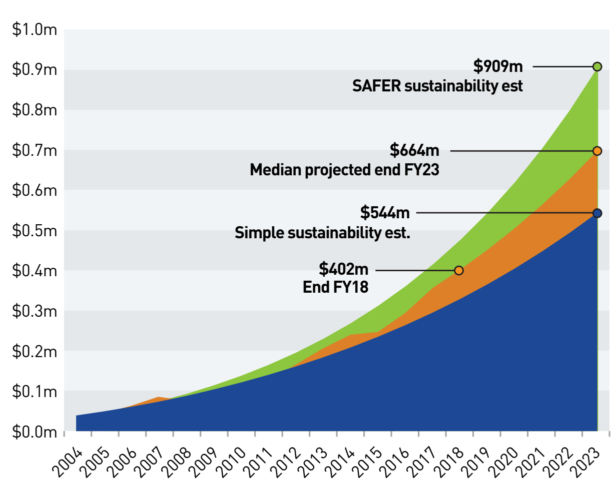
A range of factors have combined to result in a CTF value that is now above the projected path to achieve the simple sufficiency estimate by the end of FY2023. The most important factor is the effect of contributions from a third party, but also important is the investment climate that has prevailed from FY2006 through FY2018. Addressing other factors, the authors provided a lengthy discussion on delays in establishment of the CTF and further delays in implementing an investment strategy (see the FY2011 report at http://www.econmap.org).

B. Simulating the Compact Trust Fund

The RMI, FSM and Palau CTFs are described in substantial detail in a separate Graduate School paper, "Compact Trust Funds in the Three Freely Associated States: Mechanics and Stochastic Projections."[5] For the RMI CTF, we provide below a brief summary of the results of the projections for the distribution period under the existing rules as found in the Trust Fund Agreement and as compared to various alternatives.

5 See http://www.econmap.org.

Figure 34
Projected RMI Trust Fund Value through FY2023



TRUST FUND MECHANICS

Core CTF principles: CTF core principles are defined as follows:

- The real (inflation adjusted) value of the trust fund should be protected (over the long run).
- The trust fund should provide a targeted level of annual real distributions to the governments of the FAS on an annual basis.
- Annual distributions should entail minimal volatility from period to period, and, when volatility is required, the volatility should be of known magnitude to limit disruption to fiscal policy.

CTF analysis based on Monte Carlo techniques: Simulations are conducted using Monte Carlo statistical techniques based on a simple portfolio composed of equities and bonds. The value of the CTF is projected through as the corpus accumulates, and both drawdowns and fund corpus are projected over a 40-year period through FY2063.

Performance measures: Each of the core CTF principles is scored against a set of performance measures. The first two core principles have two subelements: (i) an average over the drawdown period, and (ii) a value in the terminal year. The focus is thus on both averages over the drawdown period and steady-state values measured in the terminal year. In the context of Monte Carlo analysis with 10,000 cases being run, this results in (i) an average of the observed median value for each year for each of the 10,000 cases, and (ii) an average for the terminal value for each of the 10,000 cases. The benchmarks are designed to achieve intergenerational equity.

Volatility is scored through probabilities of zero distributions and downward adjustment in distributions: In the case of volatility, two basic measures are estimated: (i) the probability of a zero distribution, (ii) the average number of years and magnitude of adjustment in years with reductions in real distributions. The first measure captures either fund collapse or, in the case of the COFA rules, the possibility that the corpus is funded but no distributions are permitted. The second measure captures downward movement in real distributions. It is split between two submeasures: (i) the average number of downward adjustments, and (ii) the average percent reduction from the prior year. The first measure penalizes any downward adjustment, and the second is weighted by the size of adjustment and is an indicator of fiscal adjustment. These measures are intended to reflect the difficulty in downward fiscal adjustment.

Benchmarks: In the discussion, three useful benchmarks are defined:

i. The **target distribution** is defined in the CTF Agreement as the real value of the FY2023 grant-assistance levels plus full inflation adjustment.

ii. The **primary-target** fund estimate is defined as the value of the CTF required to yield the target distribution in a given year based on the estimated real geometric portfolio rate of return.

iii. The **sustainability adjustor** is an empirically estimated percentage above the primary target that the CTF should attain to accommodate an "acceptable" degree of market risk.

iv. The **SAFER target** is defined as the primary target multiplied by the sustainability adjustor.

An evaluation methodology to compare different CTF rules: An important and key aspect of the approach adopted is to provide a means to evaluate the performance of different distribution rules that might be considered as alternatives. The various studies conducted by the ADB and GAO have examined a variety of different rules that might be considered but have not developed a methodology for scoring or selecting among the various alternatives. The performance indicator selected provides just such a selection of decision rule.

TRUST FUND RULES

a COFA Rules

Trust fund accumulation: The RMI CTF is composed of four accounts: the A account, known as the corpus, a B holding account, a C stabilization, or buffer, account, and a D account that can accommodate additional, segregated contributions and earnings under the control of the RMI. In the initial accumulation phase through FY2023, contributions are deposited into the A account and annual investment income above 6 percent in any year is transferred to the C account. The C account is capped at three times the projected annual sector-grant transfers in FY2023.

Distributions for the RMI during the drawdown period: During the drawdown phase after FY2023, all income of the corpus will be transferred to the B account for distribution. Distributions are capped at the FY2023 sector-grant level fully adjusted for inflation (US GDP deflator). If there are excess funds above the annual projected distribution, these are transferred to the C account until the C account reaches its maximum value of three times the FY2023 nominal drawdown level (unadjusted for inflation).

Zero distributions and shortfalls are predicted: Once the cap of the C account has been reached, any excess is returned to the corpus. If the B account has inadequate funds to meet the target distribution, these may be topped up from the C account. If the sum of the B and C accounts is below the target or if the C account has been exhausted, additional funds may not be withdrawn from the A account, resulting in a distribution shortfall. Hence the possibility of zero-distribution years.

b The Sustainability Adjustment for Enhanced Reliability (SAFER) Rule

A methodology to define a sustainable drawdown: The SAFER rule attempts to define the level of drawdown that can be sustainably achieved without jeopardizing the three core principles outlined above. More precisely, we ask what size of fund is likely to achieve sustainability and generate a score of over 95 percent on the performance indicator.

Estimating the sustainability adjustment: To define a sustainable CTF level, the primary-target indicator is used as a benchmark. Simulations are run assuming the CTF is funded at the primary-target level in FY2024. Recall that the primary target is derived through dividing the target distribution by the estimated real portfolio geometric rate of return. Simulations are run assuming CTF levels ranging from 10 to 200 percent of the primary target in FY2024 in increments of 10 percent.

Selection of a performance target: While it is not possible to unambiguously specify an optimal target level of performance, a 95 percent target has been adopted. This translates into a funding level of the CTF of 67 percent above the primary target in the initial year. At this level, the CTF corpus and annual distributions are maintained at healthy levels and volatility is reduced to a minimum. At the 95 percent level, at a strong level of confidence it can be ensured that the CTF will be sustainable in the long run. In our case, a sustainability adjustor of 67 percent has thus been selected.

The SAFER rule: The starting point of the SAFER rule is thus defined by a sustainable and initial drawdown level as the value of the corpus in the initial year (an average of the last three years is used) times the real geometric portfolio yield divided by one plus the sustainability adjustor. In effect, this amounts to discounting the portfolio average geometric rate of return of 5 percent by one plus the sustainability adjustor of 0.67; this is equivalent to a drawdown rate of 3 percent. The SAFER rule is based on drawing down 3 percent of the corpus in the initial year and fixing drawdowns in future years at this level adjusted for inflation. Our simulations have shown that based on this rule, a score of 95 percent of the performance indicator will be achieved.

Downside tail risk: In addition to defining a sustainable drawdown or distribution level, SAFER includes two allowances for tail risk, a downside and upside adjustment. In the case of the downside, we deploy a moving adjustment mechanism once the corpus falls below a given threshold in relation to the initial-year corpus value (inflation adjusted), referred to as the consolidation boundary. A downward adjustment, or decrement, of 5 percent of the previous year's distribution will be made if a three-year moving average of the CTF value falls below the consolidation boundary.[6] Downward adjustment continues until the reduction in distribution exceeds the CTF shortfall (the ratio of the actual CTF value to the inflation-adjusted base-year value). At

6 See appendix 1 for full specification of the moving adjustment rule.

this point, an upward adjustment, or increment, of 2 percent is made until distributions return to their initial-year inflation-adjusted SAFER-defined levels. Adjustment is thus asymmetric: on the downside, adjustment is more rapid, and on the upswing, adjustment is slower in order to allow the CTF to return more rapidly to sustainable levels. Once distributions return to their inflation-adjusted initial values, no further adjustments are made.

Upside tail risk: In the case of the upside, once the corpus achieves a given venting threshold above the inflation-adjusted initial-year value, a 5 percent increment is allowed. This continues until the target distribution is attained. At this point, future increases in real distributions terminate. In the case in which markets perform badly and the CTF subsequently drops below the venting threshold, downward adjustment occurs until distributions return to their initial-year SAFER-defined inflation-adjusted levels. Both the consolidation boundary and venting threshold were determined through simulation and set at 20 percent.

SAFER benefits future generations: Clearly, the initial SAFER drawdown rate of 3 percent is below the market estimated yield of 5 percent, and thus in the majority of cases when average market returns may be expected, the corpus is likely to grow. The SAFER rule thus has the unavoidable characteristic that in order to protect the corpus, a lower drawdown rate is chosen in the initial years, but that in the majority of cases over time drawdowns increase. Thus, necessary abstinence on behalf of present generations benefits the well-being of future generations and underwrites trust fund sustainability and fiscal stability.

c Fixed-Drawdown Rule

The fixed-drawdown rule is simple in concept: An alternative trust fund rule that has gained support in discussion of the FAS trust funds has been a rule based on a fixed-percentage drawdown of a moving average of the CTF corpus. The rule benefits from a simple approach to distribution and accumulation. The rule benefits from adjustment in distributions that protect the corpus as markets fluctuate but is weak in stabilizing revenues and thus fiscal adjustment during periods of weak market performance. In our simulations, a 4.5 percent drawdown rate has been selected.

COMPARISON OF THE DIFFERENT RULES

While the CTF is projected to exceed the primary target in FY2023, it is below the SAFER target: The simulations indicate that in FY2023, the RMI CTF is likely to exceed the projected primary-target value of $544 million in 82 percent of cases and attain a median value of $664 million, 22 percent above the primary target. However, this is 27 percent below the SAFER target of $907 million.

CTF performance under COFA is far from satisfactory but may be improved under alternative rule sets: While this result may suggest a favorable outlook for the future, it is far from fully satisfactory, and none of the selected rules attain a satisfactory score (see table 16 for details of the results for the different rule sets). Under COFA, in 56 percent of cases, the simulations project a zero distribution in at least one year between FY2024 and FY2064, and the overall indicator of CTF performance scores 75 percent. A considerably higher score on the performance indicator and reduced volatility can be achieved through adopting either of the alternative accumulation and distribution rules. Under SAFER, CTF performance is increased to 88 percent; it increases to 85 percent under the fixed-drawdown rule. While volatility is significantly dampened under the two rules, under SAFER there remains a small probability of CTF collapse. Under the fixed-drawdown rule, distributions suffer from a larger number of oscillations and reductions.

SAFER and the fixed rule produce the best score in protecting the CTF corpus, while COFA's performance is weak. Figure 35 indicates the probability that the real value of the CTF increases during the period under each of the three rule sets and in different time periods. For COFA the probability of maintaining the corpus value is very weak, at only 24 percent during the first 10-year period, and it declines further in each subsequent period. In the case of SAFER, the probability of maintaining the corpus's real value is about 70 percent in each period. In the case of fixed distribution, the probability rises gradually through the 40-year horizon and rises above SAFER in the last two periods.

Significant intergenerational differences between the rule sets in attaining the target distribution: In the case of attaining the target distribution, figure 36 indicates COFA scores well in the first period, attaining 84 percent of the target, but declines steadily thereafter and only achieves 43 percent in the FY2054–FY2063 period. SAFER achieves precisely the opposite; it starts out with a low achievement at 42 percent but rises in each subsequent period, until it tops out at 76 percent. This reflects the design of SAFER with a low initial drawdown to preserve CTF stability and higher drawdowns thereafter as market performance permits. In the case of the fixed rule, distributions remain largely unchanged through the period. Clearly, the performance of the different rules has significantly different intergenerational impact, with COFA benefiting current generations and SAFER and to a lesser extent the fixed rule favoring future generations.

SAFER and the fixed rule eliminate zero distributions, which are extreme under COFA: Two graphs are presented to display volatility, figure 37 and figure 38. The first graphic indicates the probability of zero distributions, with only COFA registering a positive count. Both SAFER and fixed distribution eliminate zero distributions, while the probability under COFA is large and indicates extreme volatility.

SAFER produces best result in generating stable distributions: The second graphic depicting volatility indicates the number of years that a real reduction in drawdown occurs. Under COFA, the number of years with reductions in distributions rises through time, indicating the erosion of the CTF corpus. Under SAFER, this is low at about one year in each 10-year group, reflecting that SAFER is designed to remove volatility to the extent possible and to enable the smooth uninterrupted implementation of fiscal policy. The fixed rule starts out with a number of years, similar to COFA, but over time it improves and the number of years with distribution reductions declines.

Overall, SAFER produces the best results but comes at the cost of weak initial drawdowns: Preference of the rule set clearly depends on the objectives of the CTF. COFA is badly designed and is now generally recognized as in need of replacement. The fixed-drawdown rule has been promoted because of its simplicity and protection of the corpus, but it fares less well in terms of stability and the smooth operation of fiscal policy. SAFER protects the corpus and produces the most stable distributions but comes at the cost of a low initial drawdown: it favors future over current generations.

ADDITIONAL CONTRIBUTIONS

Additional contributions can make a significant improvement but fail to achieve

Table 16 RMI Compact Trust Fund simulated results and performance under different distribution rules

	Rule sets		
Performance measures	**COFA rules**	**SAFER rule**	**Fixed interest @ 4.5% of 3-yr avg**
Compact Trust Fund Corpus results			
Probability of real CTF in FY63 > the FY23 value	70.7%	86.5%	74.9%
Probability of real CTF value > the primary target in FY63	76.6%	89.4%	77.6%
Distribution-level results			
Average distribution from FY24-FY63 as % target	90.6%	85.6%	91.6%
Probability of attaining target distribution in FY63	76.2%	72.0%	75.2%
Volatility results			
Probability of at least one zero distribution from FY24-FY63	55.6%	0.05%	0.0%
Magnitude of decline in years with reductions from FY24-FY63	6.8%	1.1%	1.0%
Frequency of years with reductions from FY24-FY63	11.4%	9.8%	17.4%
Overall performance rating	**74.9%**	**88.0%**	**85.0%**

Figure 35
Probability of real CTF increasing during period

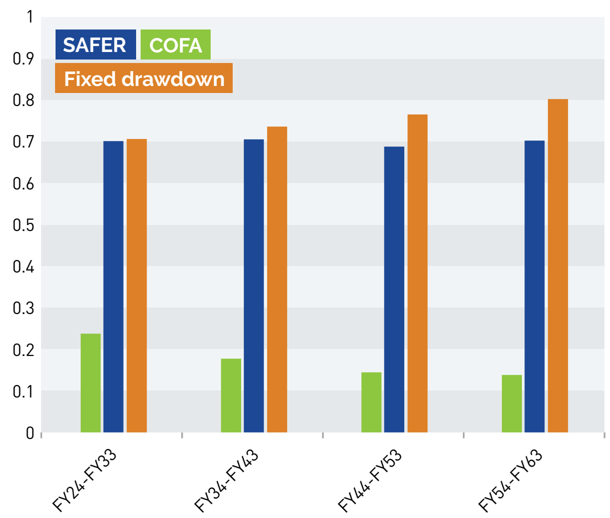
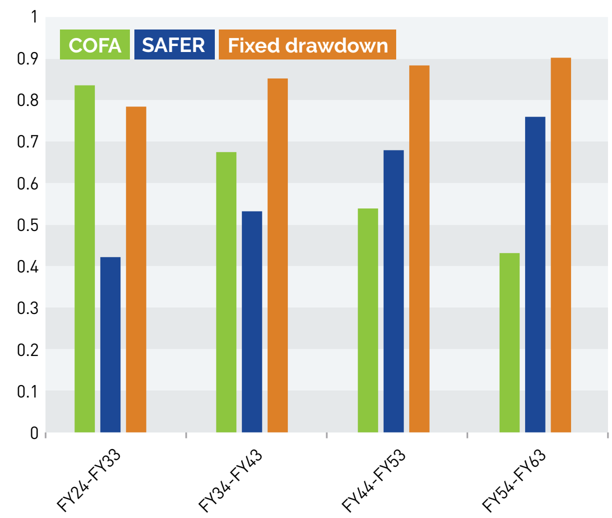


Figure 36
Average distribution % target



the sustainability target: In the first set of simulations, we assume the RMI generates and saves additional resources for contribution to the CTF. We include the D account ($16 million), compensation for the loss of the trade and investment provisions of the original Compact ($20 million), and allocation of $8 million of the existing structural fiscal surplus through FY2023 and $3 million thereafter. Unfortunately, the addition of these funds fails to add sufficient funds to achieve the SAFER threshold: the COFA rules attain a score of 89 percent, SAFER 90 percent and the fixed rule 91 percent, respectively. At high levels of funding with the additional resources, the scores of the different rule sets tend to converge. While the proximity of the results might suggest indifference to the rule set selected, SAFER remains the rule of choice as it contains desirable features for small fiscally dependent economies such as the RMI.

Extension of the Compact by 20 years comes at a cost of $901 million. Allowing for graduation after the CTF reaches a sustainable level, funding is reduced to a total of $366 million over eight years: Simulations have been included to examine the impact of extension of the Compact under alternative assumptions (see table 17). Three major alternatives are considered: (i) a direct upfront contribution, (ii) an unconditional extension of the Compact for a 20-year period, and (iii) a graduation version that entails the United States making contributions until the SAFER condition is achieved—that is, it entails that sustainable distributions can be relied on with a high degree of confidence. The upfront cost is $423 million, and a 20-year unconditional extension would cost $901 million. Under the graduation scenario, the RMI would in the median case achieve graduation after eight years at a cost of $391 million. All scenarios achieve sustainability and score greater than 95 percent.

Table 17 RMI Compact extension analysis supporting sector grants + SEG funding at FY23 real values

Performance Measures	Compact extension		
	Fully funded	To date certain	To SAFER achievement
Overall performance rating	**94.2%**	**99.1%**	**96.9%**
Number of years	1	20	8
Total cost of contributions	$423m	$901m	$391m

Figure 37
Probability of zero distribution in period

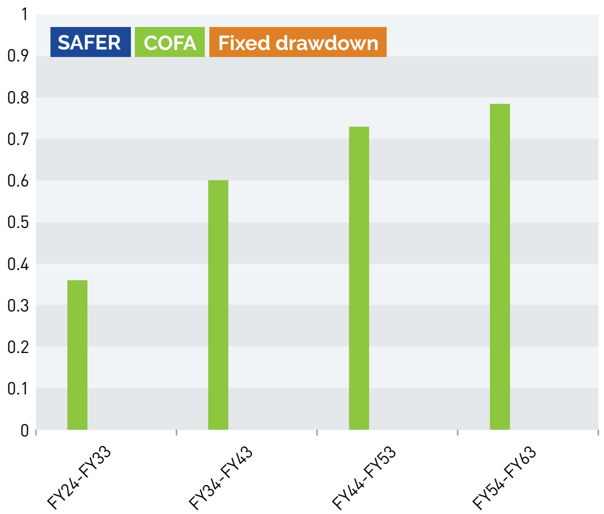
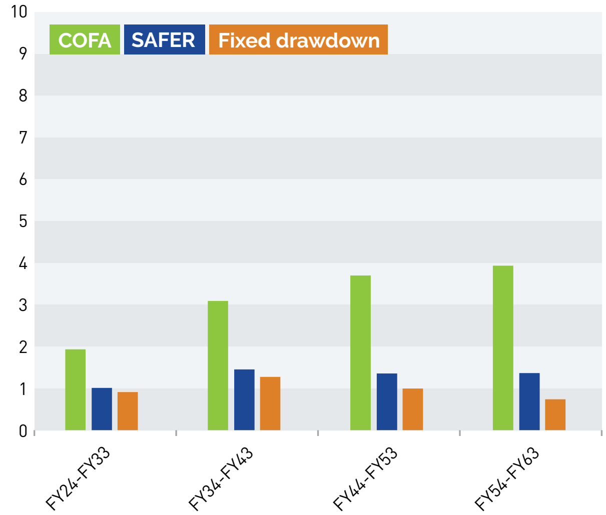


Figure 38
No of years with reductions in distributions



9. The Long-Term Economic Outlook

This chapter and the long-term economic projections through FY2030 are based on the RMI LTEFF. The LTEFF comes under the class of models known as financial programming developed by the IMF. Two projections are made: (i) a base case based on current policy, and (ii) a fiscal-responsibility reform scenario to improve PFM and promote sustainable fiscal policy.

- The base-case projection reflects the current policy environment, experience of the first 15 years of the amended Compact and revealed preference of the RMI government from the FY2018 fiscal outturn and FY2019 and FY2020 budgets. The base-case scenario thus assumes government continues its current path utilizing all available resources throughout the remaining amended Compact period. In FY2024 the economy is forced into adjusting to reduced transfers from the CTF and the programmed loss of the SEG.
- The fiscal-responsibility framework and fiscal strategy presented in chapter 4 forms the basis of the responsibility scenario. The emphasis is on fiscal consolidation and strengthening the public sector rather than on policies to promote private sector development:
    - Tax reform
    - Countercyclical reserve
    - Enhanced CTF contributions
    - Sustained SS support
    - SOE reform and adjustment
    - Reform of the Majuro landowner utility subsidy
    - Donor support through budgetary support
- Overall, the fiscal-responsibility scenario represents an approach to fiscal management that has not been evident in the past. For the reforms considered here and the achievement of long-term fiscal sustainability, a new era and culture of fiscal and economic management is required. With the large current donor interest in the RMI, the coming changes in the Compact arrangements, and challenges posed by climate change, the reforms suggest a coordinated approach between donors and RMI is needed. While the RMI has failed to adopt a reform agenda in the past, the current period of change may provide the incentive required.

9. The Long-Term Economic Outlook

A. Background

The modeling framework: This chapter and the long-term economic projections through FY2030 are based on the RMI LTEFF. The LTEFF represented attempts to capture the major economic relationships in the RMI. GDP is projected in constant and current prices, together with exogenous price and wage estimates. This forms the basis for the generation of income and includes the estimation of compensation of employees and operating surplus. The household-sector account is modeled in some detail capturing the generation of income and including primary and secondary incomes. This is channeled back into household final consumption. At this stage, estimates of gross domestic expenditure (GDE) can be made, which in turn determine output levels of some industries.

Financial programming: While revenue estimates are related to the level of economic activity and tax policy, expenditures are dependent on government policy. Estimates of the BoP and the monetary account are included. Other refinements include an external-debt module, projections for fishing fees and the MIMRA account, and projections for SS. The LTEFF comes under the class of models known as financial programming developed by the IMF. A write-up of the LTEFF is provided in appendix 2. A set of projection tables and the spreadsheet model can be downloaded from http://www.econmap.org.

Base-case scenario based on current policy but with adjustment to the reduced transfers after FY2023: The discussion in this chapter focuses on the likely growth path the economy will take during the remainder of the amended Compact and through FY2030 as the economy switches from annual sector grants to CTF drawdowns. Base-case projections of the RMI economy are made, given the current policy environment, experience of the first 15 years of the period and revealed preference of the RMI government from the FY2018 fiscal outturn and FY2019 and FY2020 budgets. The rapidly rising level of fishing fees and drawdowns of the general fund radically changed the fiscal environment facing the nation. From a constrained fiscal environment and need for decrement management, the situation presented itself as one of structural fiscal surplus. The recent budgets and outturn indicate a programmed use of all available resources, with reduced support for SS and only minor allocations to the CTF. The base-case scenario thus assumes government continues its current path utilizing all available resources. After FY2023 it assumes that the RMI must adjust to a reduced drawdown from the CTF because of the need to replace the annual sector grants and because of the programmed loss of the SEG.

The fiscal-responsibility scenario: A fiscal-responsibility scenario is simulated that quantifies many of the program elements outlined in chapter 4. With a new administration about to form and a new era evolving, the responsibility scenario presents a different focus from the recent experience. It is assumed that interest in the tax-reform initiative is reignited and introduced. It is assumed that the countercyclical reserve promoted in chapter 4 to assist adjustment to fiscal and climate events is implemented. Greater resources are allocated to SS and the CTF. The ongoing PFM reforms with ADB support and implementation of the SOEMU are assumed to encourage greater efficiency in the operation of the SOE sector with reduction in subsidies. Reforms are also made to the inefficient and rapidly growing transfers to Majuro landowners for easement rights. Finally, it is assumed that through implementation of the responsibility program, the RMI qualifies for budgetary support. The donor community supports the program and allocates part of the current aid budget to budgetary support.

B. The Base Case

ASSUMPTIONS

Fisheries: The major factors affecting the base-case projection of economic activity relate to the fisheries sector, infrastructure investment and the provision of public sector services. The fisheries industry has been an important generator of economic growth, but during the remainder of the amended Compact it is projected to grow modestly. While the output of the fish-loining plant is constrained by labor shortages, no additions to the resident purse-seine fishing fleet have been projected. However, some increases are anticipated in home-based operations of longline fishing and in the operations of the MIMRA, the local entity managing the fishing resource. The near-shore fishery and nonfish marine products are projected to grow on trend.

Construction and the infrastructure grant: In the case of construction, the use of the Compact infrastructure-sector grant has had a very significant impact on construction output. Once drawdowns under the grant had stabilized at the start of the amended Compact, use of the grant averaged $12.6 million during the FY2006–FY2011 period. In FY2012, because of a moratorium placed on the use of the grant, drawdowns fell to $5.4 million, and they averaged $2.8 million in the FY2014–FY2016 period. While in FY2015 the moratorium remained in place, project-management issues were resolved, and in FY2017 use of the grant returned to normal levels. In FY2018 grants usage, at $8.2 million, was below the amount available, with the backlog of unused funding rising to $38 million. It has been assumed that the backlog of funds is drawn down in a gradual and smooth fashion through FY2030 to avoid creating any adverse economic cycles.

Booming aid projects: In addition to the Compact infrastructure funds, there is also a significant pipeline of projects from other multilateral and bilateral donors—from the ADB, the EU, the World Bank, Japan and others. With the switch to a grant-only basis, the ADB now has a pipeline of projects of approximately $64 million available. The EU has a further €9.1 million under EDF 11 and is expected to make funding available under EDF 12. The World Bank has funding programmed at over $100 million including the Green Climate Fund under IDA 18/19. The funds are allocated for the energy sector, climate resilience, social sectors and other projects. The World Bank and ADB have large projects in building climate resilience, water and sanitation that involve significant construction activity. The nature of these projects and their composition, timing, and capacity constraints involve considerable uncertainty and are difficult to project. It has been assumed that implementation slowly builds over the remainder of the Compact and is maintained in the future. A level of infrastructure projects of $9 million is projected for FY2019, rising to $21 million by FY2021 and stabilizing and rising with inflation in the long term.

Provision of public services is maintained: Under the DMP, the government was committed to reducing payroll costs in FY2018 and FY2021. However, in the current base-case scenario it is no longer assumed the government maintains these targets in the changed fiscal environment. Rather, recent trends in public administration, education and health since FY2010 are projected to continue through the remainder of the amended Compact: public administration to grow by 2.2 percent per annum, education to fall by 1.1 percent and health to grow by 0.9 percent.

ECONOMIC ACTIVITY

Economic growth projected to improve in remainder of amended Compact: Figure 39 indicates both the level of GDP in constant prices and the annual growth rates through FY2030. The average GDP growth through the remaining amended Compact is projected to accelerate to an average 1.8 percent, above the average growth of 1.2 percent in the first 15 years of the amended Compact. The improved performance reflects the boom in donor-funded infrastructure projects.

Strong growth maintained in FY2019 but projected to decline during remainder of amended Compact: After strong performance in FY2018, the economy in FY2019 is projected to maintain the momentum with continuing growth of 3.4 percent. Use of the Compact infrastructure grant is projected to be fully utilized, but the main impetus for growth comes from the ADB and World Bank projects, although

Figure 39
Projected GDP level and growth

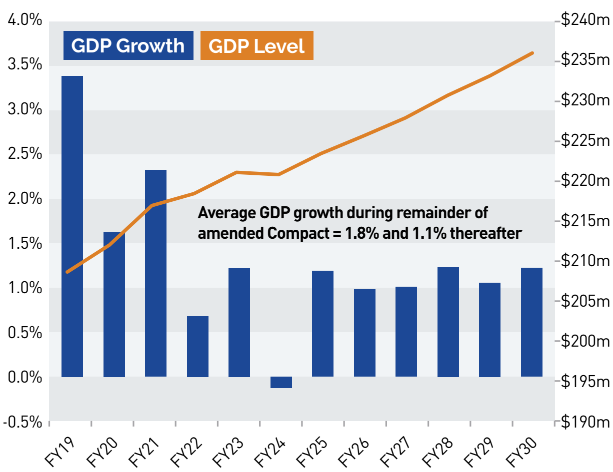
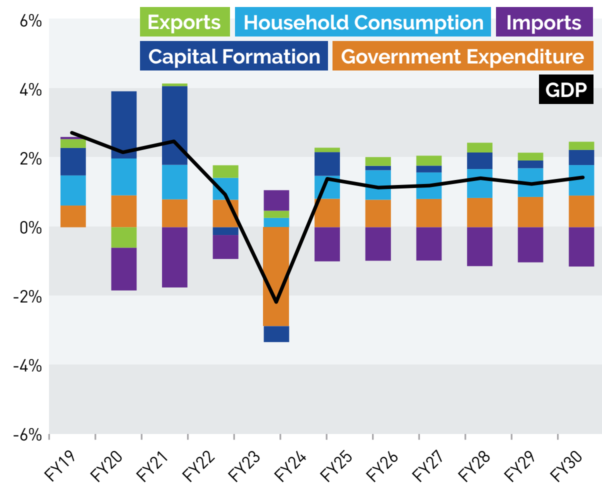


Figure 40
Sources of Growth



it is still assumed there are considerable capacity limitations. After FY2019 the same general forces exert themselves. Compact infrastructure-grant levels continue to rise through FY2023 with increasing use of the backlog of funds. The large pipeline of multilateral donor-funded infrastructure projects is projected to expand through FY2021, although the impact of these projects is difficult to project. The level of government recurrent operations is projected to increase in line with inflation and the underlying assumptions indicated in the prior section. Overall, the rate of GDP growth remains favorable but declines through the remainder of the amended Compact.

Adjustment to the CTF period: In FY2024, the first year in which the annual grant allocation switches to CTF drawdowns, there is a need for fiscal adjustment. The base-case scenario assumes that CTF drawdowns are reduced to a sustainable level (a cut of 25 percent of the base sector-grant level, or $6.6 million) and that the SEG terminates. In order to maintain fiscal balance, nonpayroll expenditures are cut back. However, while government operating services in administration, education and health are maintained without adjustment, it has been assumed that infrastructure allocations are cut to match the drawdowns from the CTF. Under these assumptions, construction activity declines, but the overall impact of the adjustment on GDP is minor: GDP declines by 0.1 percent. This is 0.6 percent lower than would have prevailed in the absence of the cost-cutting measures. After FY2025 government expenditures and infrastructure projects revert to their normal rates of growth and the economy settles at its long-term steady-state rate of 1.1 percent.

Sources of growth: Figure 40 indicates the sources of growth and their contribution to growth each year between FY2018 and FY2023. In the early period, the impact of accelerated infrastructure growth on the economy (capital formation) is the main driving force between FY2019 and FY2021, although government expenditures play an important role. In FY2024 the impact of the need for fiscal adjustment is clearly seen, together with the reduction in infrastructure. However, the selective nature of the adjustment—it avoids cuts to payroll—helps reduce the negative impact on household consumption. In the post–amended Compact era, both infrastructure and public services continue to grow, reflecting the basic assumptions built into the LTEFF. Exports, mainly fisheries, play a minor role, and they are no longer the driver of growth they were during the initial part of the amended Compact. Both household consumption and imports make up the remaining elements of demand and follow the pattern of economic developments during the period.

Employment growth remains positive during remainder of the Compact and beyond: Figure 41 provides a projection of demand for labor and annual growth in employment. The pattern reflects the growth in GDP and industrial structure and labor utilization. In the remainder of the amended Compact, employment grows by an average 2.5 and 1.4 percent during the post–amended Compact period, both higher than the corresponding GDP rates of growth. The higher rates of growth reflect the greater labor-utilization rates in government and infrastructure periods. It is noted that while employment growth falls in FY2024 as the economy adjusts to the new era, it does not turn negative.

FISCAL PROJECTIONS

Basis of revenue projections: Tax revenues are assumed to grow in line with the tax base, adjusted for estimated tax-buoyancy ratios. The major items of nontax revenues include fishing-fee royalties received by the MIMRA plus shipping-registry fees. The MIMRA account has been projected based on assuming royalties grow in line with US inflation and thus remain constant in real terms. After allowing for MIMRA expenses and development needs for local industry, the residual is transferred to government, as required by law. MIMRA revenues are assumed to grow at close to the rate of inflation. Shipping-registry fees are projected to grow through the addition of $0.5 million a year, as has been recent practice, although the terms in future contracts may be revised. Compact grants, the SEG, CTF drawdowns and the large infusion of donor funding are projected as previously discussed.

After large increase in donor funds, revenues are projected to fall by over 5 percent in the aftermath of the amended Compact: Figure 42 provides a projection of revenues and expenditures. Revenues are projected to grow rapidly in the near term with increasing use of the backlog of the Compact infrastructure grant and booming donor funds. By FY2021 the rapid increase in donor funds is assumed to have peaked, but it continues to expand in the last two years of the amended Compact. In FY2024 Compact sector grants switch to CTF distributions and drop by 25 percent, reflecting an anticipated move by the JEMFAC to set distributions at sustainable levels. The SEG also terminates, and grant revenues are projected to drop by $12 million, or 4.4 percent of GDP. Overall revenues decline by 5.5 percent in FY2024 but thereafter grow by 2.3 percent through FY2030.

Basis of the expenditure projections: On the expenditure side, payroll costs are projected on trend of recent growth in the public service and annual average increases in wage rates since FY2004. Use of goods and services is assumed to grow on trend, about 1 percent above inflation.

Figure 41
Projected employment level and growth

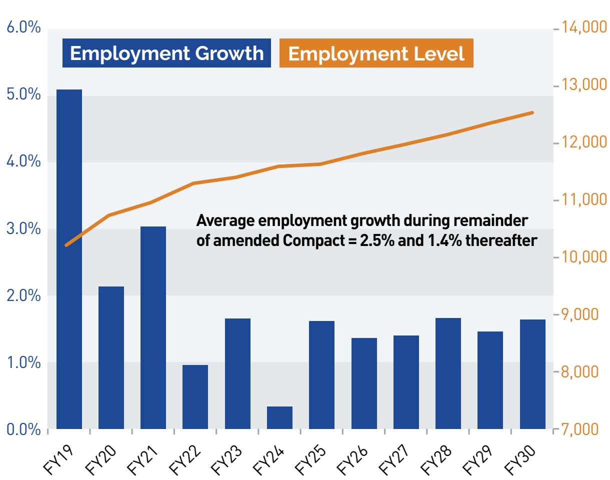
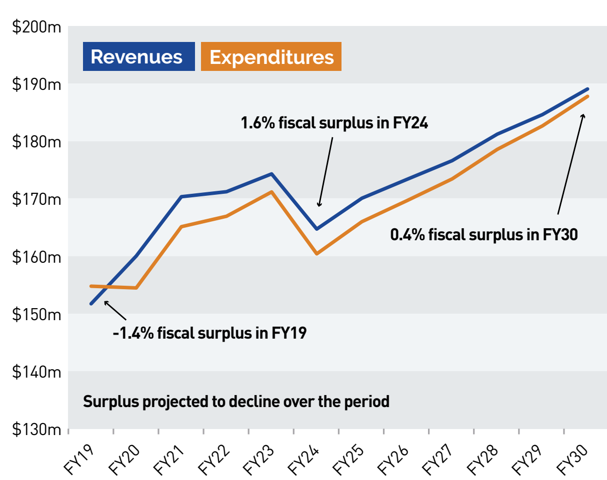


Figure 42
Projected revenues and expenditures



Subsidies are projected to rise rapidly in FY2019, reflecting the very large increases in copra price support. The FY2020 budget assumes the copra subsidy drops from the pre-election level during FY2019 of $11.3 to $5.7 million. Thereafter subsidies assume a more modest rate of growth, enough to operate the inefficient and costly sector. Grants to other layers of government are assumed to follow historical trends, apart from transfers to the MISSA, which are maintained at the FY2002 budget level of $1.7 million through FY2023. The projections indicate that this level of MISSA transfers is above operational needs and leads to a desirable increase in fund reserves. In the case of support to the CTF, the token contribution of $0.5 million included in the FY2020 budget is projected through FY2023. "Other" expense, including the $3.8 million transfer to Majuro landowners for easement rights for utility poles, rises in line with trends. Infrastructure spending reflects the grant levels that have already been itemized.

Expenditures projected to mirror rising trend in revenues through FY2023: Figure 42 provides a projection of total expenditures, which are projected to mirror the pattern of revenues, reflecting recent policy. In FY2019 a fiscal deficit results, reflecting the rapid increase in copra subsidy to support rural incomes. In FY2020 subsidies are set to fall to lower levels as indicated in the budget, albeit three times higher than in FY2015 (five years prior). Fiscal balance is restored and maintained through FY2023, although on a declining trend.

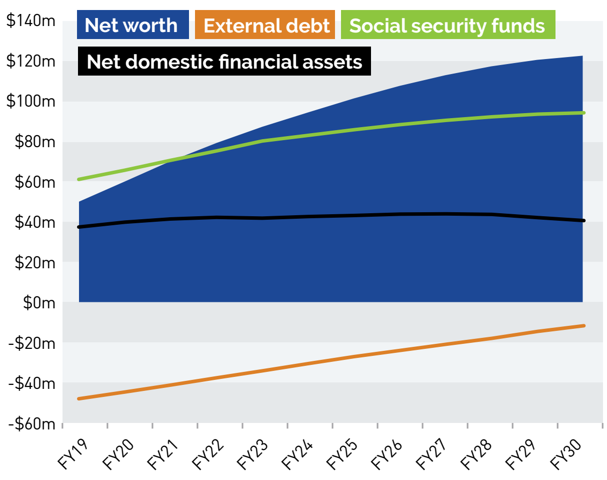
As the economy enters the post–amended Compact era, the government is forced to adjust expenditures to match the shortfall in revenues: In order to address the rapid decline in revenues of over 5 percent in the post–amended Compact era, the government has no alternative but to adjust. The main avenue of adjustment is to cut operating expenses on goods and services by two-thirds of the increase since FY2015, the level prevailing before the recent rapid fishing-fee-induced growth in expenditures. It is further assumed the government terminates further transfers to SS and the CTF. As a result, the prior rise in SS investments flattens out, although they continue to grow through the projection period. In FY2024 expenditures fall to match the reduction in revenues, and a fiscal surplus of 1.6 percent of GDP is attained. In essence, a significant part of the expenditure growth induced by booming fishing fees is squeezed out of the system. The projected fiscal surplus for FY2024 is maintained through FY2030 although at a declining rate.

Net financial worth projected to grow: Earlier discussion on fiscal responsibility indicated the objective of maintaining a rising level of government net worth over time, and the trends projected are indicated in figure 43. Net financial worth is comprised of government's net domestic financial assets, external debt and SS investments. Net domestic financial assets comprise the stock of assets at the start of the projection period plus changes in the annual fiscal deficit before allowance for change in external debt. This is indicated to remain largely unchanged through the period, reflecting the implicit target in the base-case scenario to maintain fiscal balance. Given the grant-only status now accorded the RMI, external debt is projected to fall from 30 percent of GDP in FY2019 to 4 percent of GDP by FY2030, which reflects continued debt repayment. After the reforms to SS and projected increase in retirement age from 61 in 2018 to 65 by 2025, our projections indicate a rising level of SS investments. However, it should be cautioned that while our projections incorporate the recent reforms, the benefit projections are based on the 2011 actuarial report. Pulling all the different elements of government net financial worth together, figure 43 indicates a rising level consistent with fiscal responsibility.

C. Fiscal Responsibility

In this section, we examine the implications of the fiscal-responsibility framework and fiscal strategy outlined in chapter 4. The emphasis is on fiscal consolidation and strengthening the public sector rather than on policies to promote private sector development. The reforms included in the program draw on prior and ongoing initiatives such as the tax- and revenue-modernization effort, SS reform, the ongoing SOE reforms as part of the ADB-supported PFM initiative and the DMP. The program includes establishment of a countercyclical reserve and additional funds for the CTF. Finally, it is assumed the donor community, ADB, World

Figure 43
Government net financial worth (excluding CTF)



Bank and EU support the program through allocating a portion of their existing programs to budgetary support of the following:

- Tax reform
- Countercyclical reserve
- Enhanced CTF contributions
- Sustained SS support
- SOE reform and adjustment
- Reform of the Majuro landowner utility subsidy
- Donor support through budgetary support

The tax-reform proposal outlined in chapter 4 is implemented in FY2022 and includes the introduction of a VAT and NPT of 20 percent, repeal of the GRT, elimination of customs duties, replacement of import taxes on tobacco and alcohol with excises, and reform of the wages tax. A VAT rate of 10.0 percent has been selected, which is very close to the revenue-neutral rate (10.1 percent) at time of introduction. While revenue effort is projected to be similar in FY2022, the reforms are positive over time because of the higher efficiency and buoyancy of the tax.

Establishment of a countercyclical reserve: A target level of the countercyclical reserve is established, which we assume would be equivalent to three months of domestic revenues. In FY2021 this is estimated to be $19 million, or 8 percent of GDP, and to be achieved through annual contributions equivalent to 1 percent of GDP. Not surprisingly, this takes eight years to attain, but thereafter annual earnings are more than sufficient to maintain the target. Given the nonstochastic nature of the LTEFF, there has been no attempt to simulate the impact of largely random events such as climate disturbances or market shocks.

Government to maintain contributions to the CTF and SS: In the case of the CTF, it is assumed that contributions revert to the $3 million allocated in the FY2019 budget through the end of the amended Compact. Given the proximity of the end of the amended Compact, further contributions are not likely to make a significant difference to future distributions. However, maintaining financial sustainability is a key element of fiscal responsibility and strategy. In the case of SS, the recent reforms are estimated to have improved sustainability significantly but remain inadequate to maintain a system subject to market risk. Until actuarial projections based on the current reforms and the recent "experience" study provide improved projections, it has been assumed that continuing support of the $3 million transfer will be required.

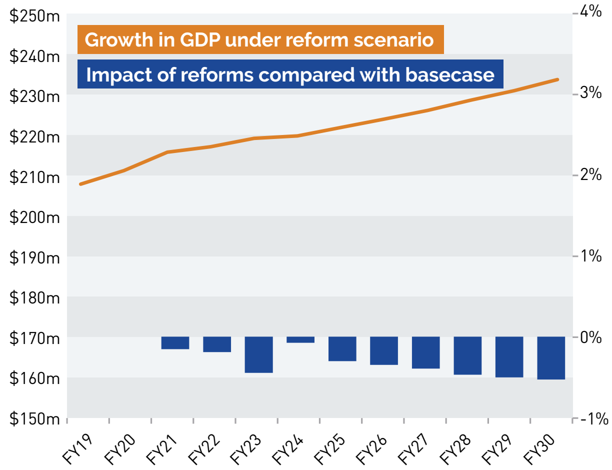
SOE reforms improve efficiency, and reforms to the Majuro landowner subsidy reduce cost: The large increase in SOE subsidies in recent budgets is reduced to prior levels, and a cut of 20 percent is made in FY2021. It is also assumed that the SOE reforms introduced as part of the PFM initiative—commercialization and payment for CSOs—bear fruit. This results in efficiency gains and further reduction in subsidies of 2.5 percent per annum. As adopted by the DMP in FY2014, the large unsustainable payments to Majuro landowners for utility support are replaced by direct payments for easement rights for power lines. A cut by 20 percent is introduced in FY2021, with further implementation of further cuts of 5 percent until total payments fall to 50 percent of the projected FY2020 level. Until a study of the value of landowner easement rights is made, it is not possible to target a fair market rate.

Donor support for budgetary support: A key element of the responsibility strategy is a request to the donor community to allocate a part of the aid program to budgetary support. Until now, the RMI has not been considered a suitable candidate for budgetary support. However, should the RMI adopt the responsibility framework and implement the reforms indicated, a change in eligibility for budgetary support should be forthcoming. Under the responsibility scenario, we assume up to 25 percent of the current grant program of $30 million could be used in this fashion, increasing from a low proportion initially (5 percent) over time as the RMI proves a responsible partner.

Expenditure measures: In the base-case scenario, a significant cut in expenditures is required to maintain fiscal balance. However, given the nature of the cuts focusing on nonpayroll, the adjustments do not impart significant hardship or burden on the population. In the responsibility scenario, the combination of the proposed reforms is sufficient that further expenditure measures are not necessary. However, in practice it may be the case that the donor community wishes to see restructuring of government expense to improve efficiency. However, in our analysis we have not attempted to rebalance the composition of expense.

Reforms have a small but negative impact on the economy: The impact of the various reforms on the economy compared with the base scenario is shown in figure 44. The reforms take hold in FY2021, and GDP is 0.2 percent lower than under the base case. Throughout the period, GDP growth is positive under the fiscal-responsibility scenario, but by FY2023 it is 0.5 percent below the base case. The fiscal policy adopted under the responsibility scenario includes the resumption of outlays in the use of goods and services that were cut in the base case. However, the responsibility scenario brings a reallocation of the aid budget from projects to budgetary support. In other words, the main impact on the economy is the shift in composition of expenditures from projects to operating expense. However, incorporated in the assumptions is that the switch to budgetary support results in a reduction in capacity bottlenecks associated with project implementation, thus increasing the level of grants received. Overall, the loss in economic growth is minor, and with increased efficiency likely to occur, the reforms would bring enhanced economic performance.

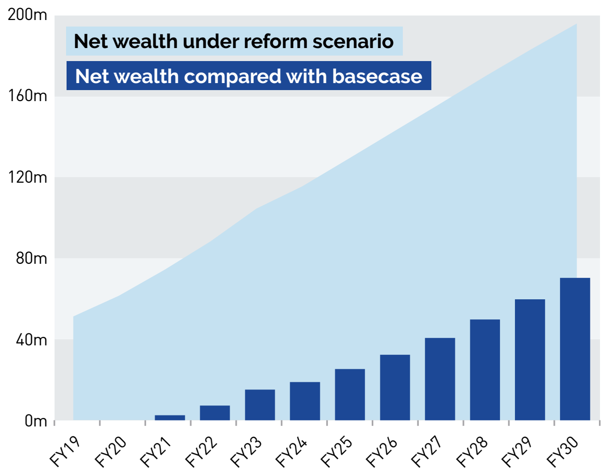
Figure 44
GDP growth under reform scenario and difference to basecase



Reforms have strong impact on revenues: Table 18 provides further details of the impact of the reform scenario on GDP, disposable household incomes, the fiscal outcome and net worth. The tax-reform component generates an increase in revenues of 0.4 percent of GDP in FY2021 at introduction, which rises to 2.0 percent of GDP in the following two years as compliance improves. The additional contributions to the CTF also make a small addition to the revenue stream after FY2023. Lastly, the greater efficiency in aid transfer due to the switch to budgetary support increases the level of grants.

Reforms largely balance out on the expenditure side: On the expenditure side, there are a series of offsetting reforms. Government needs to make additional contributions to the countercyclical reserve of $2.3 million in FY2021 and $2.5 million to the CTF to bring the total contribution to $3 million through FY2023. Contributions to SS are also increased to maintain fund viability, and the current contribution of $1.7 million reverts to the former level of $3 million. However, these increases are offset by reductions in subsidies to the SOEs and reductions in Majuro landowner utility transfers. Overall, the impact of measures affecting expenditure is to increase expenditures in the medium term but for these to fall out of the system by FY2030. Overall, this implies an improved fiscal outturn.

Figure 45
Net wealth under reform scenario and diffeerence to basecase



Net wealth accumulates strongly under responsibility scenario: Net financial wealth measures the accumulated fiscal balance, net domestic assets, countercyclical reserve, external debt, and SS investments. In terms of fiscal balance, both the base-case and responsibility scenarios target maintaining balance. Thus, there is no significant difference between the two sets of simulations. However, the establishment of the countercyclical reserve and additional contributions and accumulation of SS funds add strongly to net wealth. The reduction in external debt through the period due to the designation of grant-only status also adds to the improvement of net wealth. Figure 45 indicates the combined impact of all aspects of the fiscal-responsibility scenario on the net financial wealth of government in comparison to the base case. Net wealth accumulates significantly by 29 percent of GDP by FY2030. It is clear from the quantitative analysis presented in this section that the responsibility scenario is highly successful in achieving both the net-wealth objective and other targets of fiscal responsibility defined in chapter 4.

Reforms require a new era and culture of fiscal and economic management: Overall, the fiscal-responsibility scenario represents an approach to fiscal management that has not been evident in the past. For the reforms considered here and the achievement of long-term fiscal sustainability, a new era and culture of fiscal and economic management is required. With the large current donor interest in the RMI, the coming changes in the Compact arrangements, and challenges posed by climate change, the reforms suggest a coordinated approach between donors and RMI is needed. While the RMI has failed to adopt a reform agenda in the past, the current period of change may provide the incentive required.

Table 18 Comparison of fiscal responsibiity scenario with base-case

	FY21	FY22	FY23	FY24	FY25	FY26	FY27	FY28	FY29	FY30
GDP (diff % base)	-0.2%	-0.2%	-0.5%	-0.1%	-0.3%	-0.4%	-0.4%	-0.5%	-0.5%	-0.5%
Disposible HH income (diff % base)	-0.5%	0.7%	0.0%	-0.4%	-0.7%	-0.8%	-0.9%	-1.0%	-1.0%	-1.1%
Expenditures (diff to base)	$2.1	$0.8	-$0.6	$7.4	$5.8	$5.2	$4.6	$3.2	$0.0	-$0.4
Expenditures (diff to base % GDP)	1.0%	0.4%	-0.3%	3.4%	2.6%	2.3%	2.0%	1.4%	0.0%	-0.2%
Revenues (diff to base)	$0.9	$1.5	$3.0	$4.7	$5.3	$5.1	$5.0	$4.9	$4.7	$4.6
Revenues (diff to base % GDP)	0.4%	0.7%	1.4%	2.2%	2.4%	2.3%	2.2%	2.1%	2.0%	2.0%
Net worth (diff to base)	$2.4	$7.1	$14.8	$18.4	$24.6	$31.7	$39.7	$48.7	$58.5	$68.9
Net worth (diff to base % GDP)	1.1%	3.3%	6.7%	8.4%	11.1%	14.1%	17.5%	21.2%	25.3%	29.4%

Appendix 1

The Policy Scorecard

Table 19 provides a selected summary of various components of the RMI's policy and institutional structure that have been part of the reform agenda and have been discussed in this review. A brief summary is included in the table, with a color-coded indication of the success of the reforms.

Fiscal policy: In the fiscal-policy area, the RMI has generally achieved balance since the initial adjustment to the amended Compact. However, the operation of fiscal policy has largely been executed to appropriate all funds available without consideration of medium- or long-term objectives. Even so, the RMI is accorded the highest score in this area for attaining fiscal surplus (average 3.4 percent since FY2014).

Long-term fiscal adjustment and reforms under the CAP to address the mid-2000s crisis were not implemented once fiscal pressure moderated, despite the continuing need. The ADB PSP was partially implemented, although reforms at the MEC were the bright spot. The DMP was crafted in June 2014, but the fiscal environment has changed and the framework needs revision to reflect the changed circumstances. Overall, long-term fiscal management scores yellow.

Payroll costs rose significantly at the start of the amended Compact as funding levels increased and the reforms achieved at the end of the '90s were undone. However, since that time, payroll cost has been kept under control, although there have been significant increases since FY2017. A medium score of yellow has been recorded.

Table 19 Summary of RMI policy reforms

	Achievement	Score
Fiscal policy		
Fiscal balance	Average fiscal suplus of 3.4% to GDP achieved since FY2014	
Long-term fiscal adjustment	CAP not implemented; DMP now inactive	-
Public sector payroll	Sharp increase at start of amended Compact; slippage after FY2016	-
Tax reform	No progress after many years of active consideration	
External debt	External debt position fragile but improving 33% of GDP	+
Social security	SS reforms undertaken, but sustainability still at risk	
Macroeconomic monitoring	Full set of statistics available for economic performance assessment	
Public financial management		
Financial accountability	Accounting functions improving; capacity building initiated	
PEFA	Assessment undertaken in 2014, provides basis for ADB reforms	
National Strategic Plan	Completed May 2014 but provides few performance/monitoring criteria	
Medium-Term Fiscal Framework	New process being initiated with donor support	
Performance management	Performance budgets in some departments; no monitoring	
Information systems	Captures financial information only; legacy system under replacement	
State-owned enterprises		
Subsidies	Subsidies + capital transfers 32% of general-fund revenues; significant fiscal risk	
Divestment	No entities privatized	
Full cost recovery	All SOEs operate below full cost recovery	
SOE policy	Law passed; but board composition modified; SOE unit operational	
Regulatory environment		
FDI	No reforms undertaken, but FDI realized in fisheries sector	
Land reform	ADB TA executed; minor impact	
Doing Business Survey	World Bank survey places RMI 150th out of 190	150*

** The RMI ranked 149 in 2017.*

Attempts have been made to reform the outmoded and inefficient tax regime but have not met with success. A VAT was introduced in the mid-1990s and was almost immediately repealed because of lack of implementation capacity. A tax-reform initiative sponsored by the IMF was reintroduced in 2008, but substantial work was done afterward. Current policy after the 2015 elections was to reinitiate reforms, but no progress was achieved and the November 2019 elections have now passed (coded red).

The external-debt profile at the start of the amended Compact was adverse, and the RMI experienced a period of debt stress during the financial crisis. However, since that time, progress has been achieved in bringing the debt-to-GDP ratio down, although the RMI remains designated at high risk of debt stress according to the IMF/World Bank debt-sustainability analysis.

Reforms to the SS system have been passed into law and, coupled with annual appropriations, will assist in averting fund collapse. However, the system remains at risk, and further reforms or continuing long-run transfers will be needed to ensure sustainability. This item has been upgraded from red to yellow.

At the start of the amended Compact, the RMI had a limited set of basic macroeconomic statistics available on which to assess economic performance. Since that time, with the help of US TA, the RMI has had a full set of the major economic statistics: GDP, employment, wage data, CPI, banking statistics, BoP, IIP, external debt and government fiscal statistics. Local capacity remains weak, but capacity building is supported by international donors (coded green).

PFM: Financial management and financial accountability deteriorated significantly in late 2014 and were under threat of collapse. The FY2014 audit was delayed for eight months, and significant delays were experienced in FY2015. With recruitment of expatriate assistance, the audits for FY2016 through FY2018 were completed on time. Efforts with ADB support are in place to build capacity (coded yellow).

The RMI initiated a program to adopt the World Bank and IMF standard—PEFA—as a means of improving PFM. An assessment was made, and a PFM road map was prepared. The road map forms the core of the ongoing ADB PFM reform program and TA (coded yellow).

In 2014 the RMI completed a National Strategic Plan. However, the plan is largely a list of departmental programs and contains little quantifiable material, either in service delivery or indicators to monitor results that could be used to inform the medium-term budget process. A follow-on NSP is currently under preparation, and hopefully the deficiencies of the early version will be rectified (coded yellow).

The MTBIF was envisaged as the guiding tool of policy and budgetary resource allocation. However, while the MTBIF was initially compiled as required under the Compact, in subsequent years it was not maintained or used as an active tool of management. During the FY2019 budget preparation, with PFTAC support, a more standard medium-term budget was prepared (coded yellow).

A system of performance budgeting was implemented at the start of the amended Compact with TA supported by the United States, and some departments, Education and Health, prepared performance budgets. After a period of inactivity, processes have been reinitiated for the development of performance budgets in all departments, but there is no monitoring or performance management (scored yellow).

Financial-management information systems provide adequate accounting and audit data, but they do not provide a basis for performance management, fiscal statistics or budgeting. The current software is currently being replaced with World Bank support with a project team on the ground. Whether the new software will enable improved information, budgeting and fiscal statistics is yet to be established (coded yellow).

SOEs: The SOE sector remains a considerable risk to financial management, with subsidies and capital transfers representing 32 percent of domestic government revenues. Efforts to reduce the high level of subsidy have been made in many reform efforts, but no success has been achieved. Granted, certain SOEs are tasked with CSOs to support disadvantaged communities in the outer islands, but the level of subsidy has been growing steadily and the enterprises are not operated on a commercial basis. The recent explosion in subsidies to Tobolar for copra support presents a significant threat to fiscal stability (coded red).

Early reform programs entailed policy to divest SOEs in local shipping, public works and utilities. However, these were poorly implemented and after a relatively short period were all returned under public management (coded red).

All SOEs operate at less than full cost recovery. Improvements have been achieved at the MEC in operational efficiency and financial management, and in FY2016 the company achieved its highest profit during the amended Compact. Performance at AMI also improved, but the overall level of operating loss of the SOE sector remains high (coded red).

An SOE policy framework was drafted and enacted into law in late 2015, enshrining best practices. However, the law was amended in early 2016 to enable public servants and elected officials to serve on SOE boards, thus undermining the principle that SOE boards should be free of political influence. As part of the ADB PFM TA, an SOEMU has been established and is supporting implementation of the act. SOEs are now preparing statements of intent and business plans as required under the act (coded yellow).

Private sector regulatory environment: In general, little attention has been devoted to the private sector regulatory environment, and a recent private sector assessment conducted by the ADB indicated that little, if any, progress had been made since the prior report in 2003. No reforms have been considered to improve the regime for private investment, one of the important objectives of the amended Compact. However, despite the lack of an enabling regime, significant foreign investment has been attracted in the fisheries sector, and for that reason this area has been coded yellow.

In the area of land reform, an ADB TA initiated reforms that were subsequently enacted in law. However, the registration of land under the provisions of the act has been slow on the uptake (coded yellow).

The World Bank's *Doing Business Survey* ranks the RMI 150th out of 190 countries, a performance that has deteriorated over the last five years (coded red).

Overall, the policy, regulatory and institutional environment requires much work if the RMI economy is to be transformed and the pace of economic development and growth to accelerate. Despite these limitations, the RMI has achieved a degree of economic growth that would not have been expected for a remote and resource-scarce nation. The nation could clearly improve its performance if the various reforms that have been proposed and fully developed for consideration by the cabinet and the Nitijela were adopted, enacted and implemented.

Appendix 2

Projection Methodology of The Long-Term Economic and Fiscal Framework

The following discussion provides a description of the projection methodology of the LTEFF. The LTEFF comes under the class of models known as financial programming developed by the IMF. The model is based on the four macroeconomic accounts of a nation: the national accounts, statement of government operations, BoP and monetary survey. The four accounts are related to each other and rely on simple projection techniques that can be modeled in spreadsheets. The following notes provide a description of each of the major components of the LTEFF. While it would be possible to specify the model algebraically, the approach adopted is to describe the important elements of the system and refer the reader to the spreadsheet model. Four main methods of forecasting have been deployed. These include the following:

- Trend, whether linear, exponential or growth factor
- Constant or moving average
- Exogenous, based on policy variables or known factors such as project implementation or investment intentions
- Endogenous, linked to other economic variables in the system

PRODUCTION AND GDP

Production and GDP have for the most part been projected in constant prices (sheet "***GDP_kp***") with the current-price (sheet "***GDP_cp***") series estimated through applying appropriate price indices. The economy can be divided functionally into sets of industries that behave in a similar manner. The methodology for projecting the majority of GDP series is covered below, but for those not covered, the LTEFF contains further details.

i. **Production for home consumption**: Subsistence, or household nonmarketed, production, including ownership of dwellings, is related to the level of population, which has been growing modestly in recent years. Household production (agriculture and fishing) for the market (mixed income) is also projected on the basis of population change.

ii. **Fisheries**: There are a variety of subsectors in the fisheries industry: Pan Pacific Foods (loining plant) and Pan Pacific Fishing (purse seiners), the Luen Thai shore-based operations called the MIFV, the Koos/MIFCO joint venture (one purse seiner), the MIMRA, mixed-income and subsistence household production, and other commercial fisheries. Pan Pacific Foods is projected at a constant rate, reflecting labor shortages. Pan Pacific Fishing is projected based on discussion with the company, but no new purse seiners are anticipated in the medium term. Luen Thai, Koos, the MIMRA and commercial fishing are projected on trend.

iii. **Nontraded production for the home market**: Much of private sector production is driven by the level of aggregate demand and assumes no capacity limitations. The group includes commercial agriculture, manufacturing, wholesaling and retailing, general transport, financial intermediation, commercial real estate, business services and other private services.

iv. **Tourism**: Visitor arrivals are projected on trend, although this has been negative in much of the amended Compact.

v. **Construction**: Construction output is split between government and private sector investment demand. Government gross fixed-capital formation is projected in the fiscal account and based on the usage of the Compact infrastructure grant and other donor capital grants in current prices. After allowing for purchases of plant and equipment, the remainder provides an estimate of construction gross output; this is deflated by the construction price index. Private sector investment demand and, in turn, construction activity are estimated through a three-year lagged accelerator mechanism.

vi. **Government services**: Government nonmarketed production is considered a policy variable and projected exogenously. In the base scenario, employment is projected on trend. Local government and government agencies are projected as moving averages, while the CMI is projected to grow at a modest rate.

vii. **Taxes less subsidies on imports and products**: Taxes on products have been projected in relation to the tax base: import taxes are estimated in relation to aggregate demand, GRT in relation to private sector GDP value-added projections, and other local-government taxes in relation to the growth in wholesaling and retailing. Subsidies of SOEs have been projected as moving averages.

PRICE AND WAGE PROJECTIONS

Model prices (sheet "Prices") are projected exogenously on the basis of the small-country assumption for traded goods, while nontraded-goods prices utilize the projected level of the RMI CPI. In the case of commodity prices, the World Bank provides a very handy set of projections for the major commodities affecting the RMI: food, fuel and coconut oil. Fish prices comprise longline sashimi-grade fish and purse-seine skipjack prices. Projections are made based on long-term trends, which have been rising over the last 12 years. Consumer prices are derived as a composite index of three major groups: food, fuel and other prices weighted by RMI CPI weights. The World Bank series are used for prices of imported food and fuel, while the Congressional Budget Office's long-term forecasts of the US CPI are used for the "other" group. Projections of the US GDP deflator also utilize the Congressional Budget Office's long-term forecasts.

In the case of wages, the model assumes past trends are likely to continue into the future. Wage rates are projected on trend by institutional sector. In a more comprehensive model, wage rates would reflect labor-market conditions, but in the simplified world of the LTEFF, wage rates are projected exogenously, with a policy adjustment for the public sector, if necessary, to indicate likely trends.

GDP AT CURRENT PRICES AND THE GENERATION-OF-INCOME ACCOUNT

The projection of GDP at current prices (sheet "***GDP_cp***") is a relatively straightforward affair, with the change in GDP at constant prices being indexed to the respective price or wage indicator. In general, the constant-price traded-goods industries of the economy are inflated by the appropriate world price. For private sector nontraded goods, the CPI is used. In the case of general government, the constant-price series is multiplied by the projected wage-rate change. The sum of all industry current-price estimates provides the estimate of current GDP at basic prices. To this, the value of taxes less subsidies on products must be added. These are projected in relation to the corresponding estimates in the fiscal account. The total of all industrial production and taxes less subsidies on imports and products provides the estimate of GDP at purchasers' values.

The generation-of-income account (sheet "***GoI***") is the allocation of value added between compensation of employees, operating surplus, and taxes less subsidies on imports and products. An estimate of compensation of employees is made by industry through multiplying the prior-period compensation estimate by the increase in industry constant-price GDP and the respective wage index. The model thus implicitly assumes fixed factor proportions and allows no factor substitution. Estimates of operating surplus are derived residually through subtracting compensation from value added. Other taxes and subsidies on production are minor, are not known with any degree of accuracy and may be ignored for practical modeling purposes.

THE HOUSEHOLD-SECTOR ACCOUNT

We are now in a position to bring together the various components of the household-sector account and move toward estimating household disposable income (sheet "***Hsl_Acnt***").

Household income is generated from a series of value-added components: compensation of employees from domestic production, mixed income from production and withdrawals from quasicorporate income. Compensation of employees and mixed income from production are taken directly from the GDP estimates. Withdrawals from quasicorporate enterprises are estimated from the operating surplus derived in the generation-of-income account less an allowance for foreign ownership and domestic corporations.

Turning to primary incomes, households receive interest on savings and time deposits and make payments on loans. Significant rents are received by Kwajalein landowners, and a deduction is made for nonresident landowners. On the secondary distribution-of-income account, there are major receipts from and payments to the Social Security Administration and payments for health insurance. SS and health-insurance payments are projected to grow in line with the growth in compensation of employees. SS benefits are based on the actuarial report provided to the Social Security Administration. Households pay wages taxes and receive certain social benefits from government. These are linked to the fiscal account. Households send and receive remittances to and from the rest of the world, which are derived from the BoP. Adding up all the transactions enables an estimate of total household disposable income.

GROSS DOMESTIC EXPENDITURE AND DEMAND

The GDE account (sheet "***GDE***") is built from a mixture of current and constant prices and then either deflated or inflation adjusted to derive the corresponding series. Government final-consumption expenditure is the sum of the national, agency and local governments. For the national government, the current-price series is derived from the fiscal accounts and based on changes in compensation of employees and use of goods and services. For local government and agencies, projections are related to the GDP current-price series. The constant-price series for the national government is deflated by a composite index of wages and the cost of operations. Local government and agencies are deflated by the CPI.

Household final-consumption expenditure is composed of three elements: household acquisitions or cash expenditures, ownership of dwellings and production for own consumption (subsistence). Household acquisitions are indexed to the change in household disposable income from the household account in current prices. This is deflated by the CPI projections to estimate the constant-price series. Estimates for ownership of dwellings and for other items produced for own consumption are indexed to the respective current- and constant-price series. The estimation of consumption of output of nonprofit institutions serving households (NPISH) is driven by the growth in NPISH GDP industries in current and constant prices.

Gross fixed-capital formation (GFCF) is projected in current prices for the national government and the private sector. National-government GFCF is derived from the fiscal account, while that for the private sector is derived from a three-year lagged accelerator indexed on the cash components of current-price GDP. Both private and national-government GFCF are composed of construction and equipment components. These are deflated by a composite index of the World Bank's Manufacturing Unit Value Index and the US CPI. Changes in inventories are not projected.

Trade in goods and services is estimated from the sum of export and imports. Exports of goods comprise fish, fuel re-exports and a small quantity of others. These are all derived from the BoP. Services exports include tourism, shore-based services to fishing vessels, and others, which, again, are derived from the BoP. Constant-price exports are derived through deflation by the appropriate price series. Imports are divided into major groups: food, fuel, vessel provisioning, other imports of goods, and service imports. Imports are projected in constant prices with the current-price series estimated from the appropriate inflator. Food imports are projected according to change in real household disposable incomes and adjusted by an estimate of income elasticity of 0.5. Imports of fuel are projected in relation to constant-price GDP growth with an income elasticity of 0.8. Boat provisioning is projected in line with Pan Pacific Foods output in constant prices. Other imports are related to real aggregate demand with an income elasticity of 1.1. Imports of services are captured from the BoP and deflated by the CPI.

Adding final government and household consumption expenditures to GFCF provides an estimate of GDE. Adding the trade account to the GDE estimates provides an estimate for GDP by expenditure, GDP(E). Aggregate demand is estimated as the sum of GDE and exports and is used to derive many of the series in the LTEFF. Finally, the difference between GDP(P) and GDP(E) is the national-accounts discrepancy and provides an estimate of the overall reliability of the LTEFF series.

GOVERNMENT FINANCE

The fiscal account (sheet "***Fisc***") comprises revenues, expenses, outlays on nonfinancial assets and financing. Revenues comprise three major categories: taxes, grants and other revenue. The wages tax is indexed to the compensation-of-employees estimate in the generation-of-income account plus an allowance for buoyancy, 0.84. The GRT is projected in relation to the sum of private sector GDP estimates and again multiplied by an allowance for buoyancy, 1.01. Customs duties are projected on the basis of aggregate demand times a buoyancy rate of −0.14. (MICT estimates have been included if a reform option is selected from FY2017 onward, with the series projected in relation to household acquisitions of goods and services.) Fees collected from the ship registry are based on the FY2018 budget with an assumed $0.5 million increase thereafter.

Under grants, operational Compact sector grants were estimated from the projected level of grant assistance under the Compact times two-thirds of the US GDP-deflator estimates (sheet "Grants"). In the case of the infrastructure grant, disbursements have now returned to normal. However, the backlog of unused funds is assumed to be disbursed between FY2018 and FY2023 on a smooth path. Other grants—federal programs and the Taiwan grant—have been projected as moving averages. The major component of other revenues is transfers from the MIMRA of revenues collected from fishing fees (sheet "Fin"). The MIMRA account has been projected to remain constant in real terms from FY2016, but an allowance has been included over time for inflation in fish prices above the projected CPI. Based on PL 2016-23, the MIMRA Surplus Funds Amendment Act of 2016, all funds in excess of operations needs and fishing-industry development are transferred to government.

Government expense comprises compensation of government employees, use of goods and services, subsidies, debt service and transfers. Compensation of employees has been assumed to grow in relation to the current-price GDP estimates. It comprises trend increases in employment levels from FY2010, with an allowance for increases in wage rates based on wage drift. Use of goods and services is projected on trend, which is 1.3 percent above the long-run CPI projections. Subsidies to SOEs have been projected in accordance with the FY2018 and FY2019 budgets and thereafter determined by historical operational requirements (sheet "Fin"). Grants to government agencies are described in moving averages. Other items of expense include transfers to households and nonprofits. Accumulation of nonfinancial assets is equated with the use of the infrastructure grant plus an allowance for locally funded capital projects. Until FY2016, locally funded infrastructure was about $3 million, but this jumped in FY2017 and FY2018 with the large increase in resources available from booming fishing fees.

On the financing side, the fiscal accounts include a simple debt module comprising existing debt obligations and projections for the incurrence of future debt (sheet "Fin"). The existing debt profile and debt-repayment schedule is known with precision. Subsequent to the designation of the RMI as grant only (following the IMF DSA analysis concluding that the RMI is at high risk of debt stress), incurrence of national-government future debt obligations has been set to zero. However, it has been assumed that the SOE sector continues to borrow, although at a low rate of 1 percent of GDP, which may not be realistic given the grant-only designation. The residual on the fiscal account is the domestic resource cost and is allocated to the net acquisition of domestic deposits.

BALANCE OF PAYMENTS

The BoP is specified in sheet "***BoP***." Exports of fish, coconut oil and re-exported goods are indexed to current-price GDP estimates for the respective items. The import projections are linked to the GDP(E) current-price projections. Exports of shore-based services are linked to the current-price GDP projections, and the tourism figures are linked to the projections of visitor arrivals. The main items of import of services include business services and freight and insurance on merchandise imports. Freight and insurance are linked to import of goods, while business services are linked to current-price GDP.

The major items of primary income receipts are compensation of employees from Marshallese workers on the US military base, Kwajalein landowners' receipts from the Compact, fishing-fee royalties, ship-registry receipts, and interest and dividend earnings on overseas investments. Marshallese workers' earnings are projected in the generation-of-income account and assumed to remain constant in real terms, with an allowance for inflation. Kwajalein landowners' receipts are specified in the Compact and indexed to two-thirds of the US GDP deflator. Fishing-fee receipts are estimated from the MIMRA account, while ship-registry fees are taken from the fiscal account. Dividend and interest earnings are relatively minor, although significant interest is earned on the trust funds held by the nuclear-affected atolls, projected as a moving average.

The main items of primary income payments are payments to nonresident Kwajalein landowners, dividend payments and interest payments. A certain number of landowners are nonresident, and payments are made in fixed proportion to the receipts. Dividends of fishing companies have been related to fishing GDP earnings, while other foreign-company earnings have been projected in line with nominal GDP. Interest payments are related to projected external-debt servicing.

Secondary income flows are dominated by grants and receipt of Compact and other grants and are consistent with the fiscal account. Tax receipts are received from employees of the US military base. Household remittances, both inward and outward, have been projected in line with the household account.

The capital account is dominated by use of the infrastructure Compact grant and more recently from multilateral donors. These are linked to the fiscal account. On the finance account, FDI has been restricted to reinvested earnings of foreign companies, estimated in proportion to the dividend outflows. The major items of portfolio investment have been the drawdown from the nuclear-affected local governments' trust funds, which have been assumed to remain unchanged. SS reforms include an annual $3 million transfer to the fund, which will avoid the need for drawing down reserves. There are thus no changes in the corresponding BoP financing. Other investments reflect the buildup of offshore commercial bank foreign assets, reflecting the growing level of domestic liquidity, and are linked to the monetary account. Incurrence of external debt is consistent with the fiscal account of the national government and with similar projections for the SOE sector, projections that are derived from the external-debt projections.

BANKING SURVEY

The banking survey (sheet "***M&B***") has been included in the LTEFF for completeness, although the projections are simple. Deposits are projected in line with the growth in nominal GDP, reflecting the monetary approach implicit in financial programming. Government deposits reflect the change in net domestic financing of the national government. The capital accounts are projected on trend, reflecting the buildup of BOMI's profits. Commercial loans are projected in line with nominal GDP, while consumer loans are projected in line with the growth in compensation of employees. Foreign assets are the residual on the account.

FULL REPORT

November, 2019

ECONOMIC REVIEW

RMI FY 2018

This review has been prepared to assist the government of the Republic of the Marchall Islands and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting obligations under the FSM Compact of Free Association with the United States. RMI is required, under Title One, Section 215, to report to the U.S. president on the use of sector grant assistance and on progress in meeting mutually agreed programmatic and economic goals. Under Title One, Section 104.h, the president is required to submit a similar report to Congress concerning developments in RMI.

This review has been prepared by the Economic Monitoring and Analysis Program (EconMAP) of the Graduate School USA, with funding assistance from the United States Department of the Interior's Office of Insular Affairs. It is not intended to directly fulfill the reporting requirements of the Republic of the Marshall Islands and U.S. governments, but rather to provide an independent assessment of RMI's economic performance and policy environment, as well as independently verified economic statistics. While the reporting requirements of the two governments differ, much of the material herein will be directly relevant to the two reports.

Additional information on the EconMAP program, as well as a digital copy of this report, is available online at http://www.econmap.org