ECONOMIC REVIEW
RMI Fiscal Year 2017

December, 2018

FULL REPORT
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>Compact</td>
<td>second phase of the Compact, FY2004–FY2023</td>
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<tr>
<td>AMI</td>
<td>Air Marshall Islands</td>
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<td>AusAID</td>
<td>Australian Agency for International Development</td>
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<td>BoP</td>
<td>balance of payments</td>
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<tr>
<td>CAP</td>
<td>Comprehensive Adjustment Program</td>
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<tr>
<td>c.i.f.</td>
<td>cost, insurance and freight</td>
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<tr>
<td>CMI</td>
<td>College of the Marshall Islands</td>
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<td>Compact I</td>
<td>RMI Compact of Free Association with the US</td>
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<td>Compact I</td>
<td>first 17 years of the Compact, FY1987–FY2003</td>
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<td>CPI</td>
<td>consumer price index</td>
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<td>CTF</td>
<td>Compact Trust Fund</td>
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<td>DMP</td>
<td>Decrement Management Plan</td>
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<td>DSA</td>
<td>debt-sustainability analysis</td>
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<td>EPPSSO</td>
<td>Economic Policy, Planning and Statistics Office</td>
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<td>FAA</td>
<td>Federal Aviation Administration</td>
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<tr>
<td>FDI</td>
<td>foreign direct investment</td>
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<td>f.o.b.</td>
<td>free on board</td>
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<td>FSM</td>
<td>Federated States of Micronesia</td>
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<td>GDE</td>
<td>gross domestic expenditure</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GFS</td>
<td>Government Finance Statistics</td>
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<td>GNDI</td>
<td>gross national disposable income</td>
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<td>GNI</td>
<td>gross national income</td>
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<td>GRT</td>
<td>gross receipts tax</td>
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<td>ICT</td>
<td>information and communication technology</td>
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<td>IIP</td>
<td>international investment position</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>JEMFAC</td>
<td>Joint Economic Management and Financial Accountability Committee</td>
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<td>KAJUR</td>
<td>Kwajalein Atoll Joint Utility Resources</td>
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<td>KALGOV</td>
<td>Kwajalein Atoll Local Government</td>
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<td>MALGOV</td>
<td>Majuro Atoll Local Government</td>
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<tr>
<td>MEC</td>
<td>Marshalls Energy Company</td>
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<td>MFF</td>
<td>Macroeconomic and Fiscal Forecasting Framework</td>
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<td>MIDB</td>
<td>Marshall Islands Development Bank</td>
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<td>MIMRA</td>
<td>Marshall Islands Marine Resources Authority</td>
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<td>MIR</td>
<td>Marshall Islands Resort</td>
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<td>MISC</td>
<td>Marshall Islands Shipping Corporation</td>
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<td>MISSA</td>
<td>Marshall Islands Social Security Administration</td>
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<td>MOE</td>
<td>Ministry of Education</td>
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<td>MOH</td>
<td>Ministry of Health</td>
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<td>MOPW</td>
<td>Ministry of Public Works</td>
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<td>MOTC</td>
<td>Ministry of Transport and Communications</td>
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<td>MTBIF</td>
<td>Medium-Term Budget and Investment Framework</td>
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<td>MWSC</td>
<td>Majuro Water and Sewer Company</td>
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<td>NEER</td>
<td>nominal effective exchange rate</td>
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<td>NTA</td>
<td>National Telecommunications Authority</td>
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<td>PEFA</td>
<td>Public Expenditure and Financial Accountability</td>
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<td>PFM</td>
<td>public financial management</td>
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<td>PFTAC</td>
<td>Pacific Financial Technical Assistance Center</td>
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<tr>
<td>PM&amp;O</td>
<td>Philippines Micronesia and Orient Line</td>
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<td>PMOP</td>
<td>PM&amp;O Processing Plant</td>
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PNA — Parties to the Nauru Agreement
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
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.
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The views, thoughts, and opinions expressed in this review are those of the authors and represent an independent assessment of the economic performance in the Republic of the Marshall Islands (RMI). This document does not necessarily represent the views of the government of the RMI, the government of the United States, the Department of the Interior, the Graduate School USA, nor any other organization, committee, group, or individual, real or implied.

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 FY2017, 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 new chief secretary, 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, as well as the statistical appendix.

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

The RMI FY2017 Economic Review has been organized into nine chapters:

1. The economic-developments chapter is largely descriptive and provides a review of gross domestic product (GDP), economic performance and structural change. Demographic trends and migration are discussed together with real income levels, distribution and poverty. Trends in employment, wages and prices are outlined.

2. The second chapter reviews the external sector: balance of payments and debt sustainability together with a discussion of competitiveness and the real exchange rate.

3. A review of fiscal developments is undertaken: the framework under which fiscal policy is implemented and recent fiscal performance. The tax regime is outlined together with trends in expenditures and fiscal balance.

4. The public sector chapter outlines the operation of public financial management in the RMI, and various recent efforts at fiscal adjustment and tax reform.

5. The state-owned enterprise (SOE) chapter reviews the large SOE sector, trends in subsidies and fiscal implications. A brief review of the individual enterprises is undertaken.

6. The financial-sector chapter includes a discussion of developments in the banking sector together with the Social Security system and recent interest in the RMI to adopt a cryptocurrency.

7. The private sector chapter reviews a recent assessment undertaken by the Asian Development Bank (ADB) and the World Bank’s Doing Business Survey. The chapter also discusses the RMI Trust Company and ship registry, together with the domestic fishing fleet.

8. The Compact Trust Fund (CTF) chapter provides an assessment of the performance of the fund and the probability of attaining the objectives of the CTF subject to market risk.

9. The final chapter reviews prospects for the economy during the remainder of the amended Compact and through FY2030. A baseline projection is made based on current fiscal policy, and an alternative fiscal-responsibility scenario is simulated.
A. Recent Economic Performance: FY2017

**ECONOMIC PERFORMANCE**

The RMI economy performed well in FY2017 with 3.6 percent growth in GDP, improving on the 2.0 percent attained in FY2016 and the two previous years of negative growth. During the last two years, the major driver of the improved performance was 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. In FY2017, fisheries production improved with an increase in the fish catch. However, regulatory issues in conforming to international shipping requirements, which affected production in FY2016 and FY2017, have now been put in abeyance, while suitable measures to ensure compliance are put in place. Without the impact of fisheries, GDP in the underlying economy grew by 2.9 and 2.8 percent in FY2016 and FY2017, respectively. Public administration also had a significant impact on growth during the last two years with the expansionary fiscal policy pursued by the government.

**EMPLOYMENT**

During the amended Compact, employment growth averaged 0.7 percent annually, but the majority of the growth was in the initial years through FY2010. Since that time, employment levels have remained little changed. While employment at the central government has grown modestly by 0.6 percent since FY2010, that in the public sector at large has grown by 1.8 percent per annum, reflecting increased employment opportunities in the SOE sector, government agencies and local government. Meanwhile, private sector employment has fallen by 1.9 percent, offsetting the increase in the public sector. Clearly, employment generation in recent years has been unable to provide an increasing source of job opportunities for a growing labor force.

**INFLATION**

After a period of negative inflation in FY2015-FY2016 with falling world oil prices, inflation in FY2017 stabilized, recording a 0.0 percent change. This follows negative inflation of 1.5 and 2.2 percent in the previous two years. Food prices fell by 0.5 percent in FY2017, and transportation costs rose slightly by 0.2 percent. Overall, the reductions in prices over the last three years have helped moderate the cost of living.

**WAGES**

Wages have grown modestly in the RMI by 2.5 and 1.4 percent per annum in the private and public sectors, respectively, in the amended Compact since FY2003. However, once inflation has been taken into account real wages have fallen in the two sectors by 0.2 and 1.3 percent, indicating declining standards of living. Only at the Kwajalein military base have wages managed to maintain their real levels.

**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 48 percent (with FSM at 23 percent and Palau at 12 percent). The improved 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 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 secure-transactions legislation and registry. With limited opportunities, commercial banks have preferred to invest their assets offshore in more secure markets.

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). The BOMI has been under threat of losing its correspondent bank, First Hawaiian Bank. It is understood that First Hawaiian has been satisfied with recent progress at the BOMI in tightening AML (anti-money-laundering) and CFT (combating the financing of terrorism) procedures, but a permanent CBR solution needs to be found. Until such time, the BOMI and the RMI financial sector remain at significant risk.

A further issue relating to banking is the high ratio of consumer debt to household incomes. Consumer debt is 34 percent of GDP and 61 percent of compensation of employees. Consumer debt attracts high rates of interest—13 percent in FY2017—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 contributions and the like and after as much as 50 percent is deducted for loan repayments, national-government employees are left with an average of 15 percent net take-home pay.

Nevertheless, external debt continued to decline as a percentage of GDP, falling from a level of 72 percent at the start of the amended Compact to 35 percent in FY2017. As for debt service, total debt repayments of principal and interest represent 11 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 ADB, the RMI is no longer eligible for concessionary-loan finance. This has both benefits and costs, but ushers in a period of declining debt to GDP as existing loans are repaid. Recent interest in having government embark on projects funded by social-sector loans ($80 million, or 34 percent of GDP), which is not compliant with the World Bank’s grant-only status, threatens to undermine access to donor grants and needs to be reviewed carefully. It is also understood that viable projects such as energy-sector loans can be made an exception to the grant-only restrictions on the basis that the terms of the loan are considered as concessional.

**SOCIAL SECURITY SUSTAINABILITY**

A major pressing fiscal issue facing the RMI has been the potential collapse of the social security 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. However, the mismatch between contributions and benefits remains and is growing 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 to shore up the fund—a level of payment that must be sustained into the future to avoid fund collapse.
without further basic reforms to the system. This will require strong commitment given other priorities the RMI will face after FY2023 with anticipated reductions in Compact funding.

CRYPTOCURRENCY AND THE SOV

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 dollar. An “appointed organizer,” appointed by the cabinet, is to take responsibility for the initial currency offering (ICO), 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.

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 have been cautious to issue 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 (AML and CFT). 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.

Another concern has been the risk to the CBR relationship of the Bank of Marshall Islands with First Hawaiian Bank. Clearly, AML and CFT risks associated with cryptocurrencies may adversely affect the BOMI’s CBR with First Hawaiian and other international banks, and its ability to establish its own facilities in the US. 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 accepting and holding SOVs on the balance sheet. A further issue is volatility in the value of cryptos, which have displayed high levels of value volatility. Should the SOV be taken up actively within the RMI, this could prove highly destabilizing and disrupt orderly payments. While this might not have been the intention in the design of the system, the currency is being issued as legal tender. The government’s current position, which has emerged since the enactment of the legislation, is that the RMI will not proceed with coin issue until the issue 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.

C. Fiscal Performance and Policy

THE FISCAL OUTTURN

The RMI achieved a large fiscal surplus in FY2017 of 4.3 percent of GDP, the third year in a row of strong performance. Revenues grew strongly, reflecting very buoyant growth in taxes, but also large increases in nontax revenue: fishing fees and receipts from the corporate and ship registry. From a level of $4 million in FY2012, fishing fees received by government attained a level of $40 million in FY2017, up from $26 million a year earlier. However, this included a large transfer of prior fishing receipts accumulated by the Marshall Islands Marine Resources Authority (MIMRA) but not disbursed to government. The FY2017 revenue receipts were thus exceptional and are expected to return to former levels in FY2018.

On the expenditure side, payroll expense grew strongly in FY2017 by 8 percent ($3.5 million), breaking with the restrained growth of prior years. Use of goods and services grew modestly by 1 percent ($0.2 million). Subsidies and transfers, which also grew strongly (by $3.6 million, or 30 percent), continue to pose
a significant fiscal threat. The other most rapidly growing item was “other” expenditures, which ballooned by $6.4 million, or 82 percent. Overall, FY2017 was a blowout year for public expenditures, which grew by $15 million, or 14 percent.

The very significant improvement in the fiscal position has unfortunately been accompanied by large matching increases in budgets during the last three fiscal periods. 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, while the Compact Trust Fund (CTF) corpus is insufficient to reliably replace the grants and the social security system is underfunded.

**TAX REFORM**

With a tax/GDP ratio of 18 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 the 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, 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. There has been some reconsideration of the proposal. However, it is now 30 months into the electoral cycle and time is running out if the laws are to be passed before elections come again at the end of 2019. The failure to reform the tax system has put on hold efforts to improve tax administration: improved management practices, adoption of modern procedures, staff training and new ICT (information and communication technology) 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 to support both tax-collection efficiency and improvement of key economic-information flows, such as trade data and indicators on domestic business production.

**D. Public Financial Management**

**PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY (PEFA)**

In December 2011, the RMI underwent an external PEFA assessment and the cabinet adopted the report and directed the government to ask the PFTAC to compile a PFM “roadmap.” In collaboration with the government, the PFTAC prepared a roadmap for 2014–16, but no action to implement the roadmap 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 roadmap providing the focus of the reforms; 6 key areas were selected out of the 30 included in the roadmap. One selected area was the establishment of an SOE-monitoring unit, which is part of the ADB PFM project. The European Union (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 public financial-management reforms as part of the conditions. Both the ADB PFM and EU energy project will support and encourage improved PFM.

**FINANCIAL MANAGEMENT INFORMATION SYSTEMS (FMIS)**

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

With public payroll representing a high proportion of GDP, 22 percent in FY2017, careful monitoring of trends is warranted with anticipation of declining resources after FY2023. At the start of the amended Compact, there were 1,999 public servants, while today there are 2,484. However, the significant increase of 20 percent occurred in the first two years in response to the depressed levels of public employment after the reforms of the late 1990s. Since FY2006, only another 82 positions have been added. 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 slightly since FY2004. While the government has maintained discipline since FY2006, the increase at the start of the amended Compact indicates the scope for rightsizing when the government was operating in a leaner environment and indicates the potential for efficiency gains.

SOE REFORM

With high levels of subsidies and capital transfers to the SOE sector, at an average of 10 percent of GDP over the last three years, the ailing sector remains a major issue of concern. Recent legislation, the 2015 State Owned Enterprise Act, requires SOEs to operate on a commercial basis, with identification of community-service obligations, and requires the establishment of an SOE-monitoring unit 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 militates 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 SOE-monitoring unit. 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 policy to declare the RMI 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 and a likely further increase to $13 million. Under IDA 18 and with grant-only status, the World Bank is understood to have resources to the tune of $20 million annually. 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 under NZ aid. All in all, there is approximately $250 million in possible projects, a quantum leap in planned donor-supported activity, but there is a severely limited capacity to implement the projects on the ground. For an office that is 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 from $8.5 million in constant prices at the start to $17.6 million in FY2017. Total fish licensing and associated fees collected by the Marshall Island Marine Resources Authority have also grown from $1.3 million to $34.1 million in FY2017, much of it in the last four years because of the implementation of the Parties to the Nauru Agreement (PNA). The PNA is a cartel of nine Pacific Island states, which, because of the introduction of the Vessel Day Scheme (VDS), has led to a remarkable increase in member-country
revenues. Daily fishing rates currently average over $10,000 per vessel-day, and the RMI received over $25.4 million of revenues from this one source in FY2017.

A particular issue of 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 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, about half the going rate. 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, 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, but at significant loss to capture the rent from the reduced domestic fee rate. A comprehensive analysis is needed to evaluate whether the domestic fleet makes a contribution to the RMI economy in excess of that generated from third-party foreign fleets, and thus whether the nation would be better advised to license all of its Party Allowable Effort at full VDS rates.

THE WORLD BANK’S DOING BUSINESS SURVEY

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 scores 149, 78 percent down the list, indicating much room for improvement. The RMI fares worse than Palau but better than the FSM, which are ranked 130th and 155th, respectively, but is substantially below most of the South Pacific nations. Tonga is ranked 89th, Samoa 87th, Vanuatu 90th, Fiji 101st, and Papua New Guinea 109th. 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 for the private sector. There are many areas for reform. 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 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 (FDI)

FDI is regulated by the Foreign Investment Licensing Act of 2005, but the act appears to have failed to simplify the process. FDI permitting is done manually, 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, Social Security registration, and so on, have been fulfilled. To reduce uncertainty, an automatic process is required in order to allow other legal requirements to be fulfilled on a separate timeline from the timeline 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 for statistical and after-care procedures, and licenses should be issued in a matter of days.
LAND TENURE

In the RMI, like 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, as 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, a 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 lodged. Despite the slow uptake, the 2004 legislation and the LRA are generally considered as providing 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 Compact Trust Fund experienced market gains during FY2017 of 14.1 percent. Together with a scheduled contribution from the US of $16.1 million at the outset of the year and of $2.4 million from Taiwan midyear, those gains enabled the fund to grow in size by $62.4 million to an end of FY2017 balance of $356.9 million. During the period of investment since the outset of FY2006, the annualized rate of return has been 6.84 percent.

Assuming the pledged contributions from Taiwan continue, the CTF would only need to grow at 2.1 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 ($26.55 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. 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.

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 finding is that the size of 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 Adjustment for Enhanced Reliability) sustainability estimate for its CTF would require growth at 12.2 percent annually from FY2018 to FY2023.

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

POST-AMENDED COMPACT UNCERTAINTIES

Annual sector grants, infrastructure, and disaster assistance are set to expire in FY2024 except for those dedicated to Kwajalein. The loss of approximately $26.5 million annually is targeted to be replaced through funding provided from distributions from the Compact Trust Fund; however, there is considerable uncertainty over the continuation of many other special and federal programs and services the RMI receives from the US. In particular, the RMI benefits from the Special Education Grant (SEG), which was cashed out from former federal programs provided in the original Compact. Funding is provided through annual congressional
appropriations whose continuation post-FY2023 will end 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 Compact Trust Fund is estimated to be $5 million after FY2023, the range of possible values in the loss of federal programs may in the worst 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 arrival of the Compact Trust Fund era.

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 Inc. 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 2017 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 TCMI. There is no publicly available financial information on 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.

STATISTICAL ISSUES

In former Gradual School 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 on which to monitor 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 sessions of the Nitijela in January and August. The annual statistical update is timed to coincide with the release of the government audits and be out 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 tax and customs for both trade and the gross revenue taxes inhibit comprehensiveness and timeliness, and need replacement with modern systems. While the more frequent provision of 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, the RMI has entertained numerous reform initiatives that have failed to achieve successful implementation. The expenditure proposals of the Comprehensive Adjustment Program (CAP) were not implemented, and although there is renewed interest in the tax reform initiative, the outcome is uncertain with a lack of public awareness of what the reforms entail. While the SOE Act has become law, adoption of the “best practices” enshrined in the act requires effective implementation. The fiscal-responsibility and debt-management bill of 2012 appears to be no longer part of the legislative agenda. While there is no doubt that the refinancing of the Marshalls Energy Company (MEC) debt under an ADB program (policy reform) loan had a beneficial result, the fiscal targets of the program were not achieved.
THE LONG-TERM FISCAL GAP

In FY2016 and again in FY2017, the government enacted expansionary budgets, increasing general fund appropriations by $12 million (26 percent) and $25 million (44 percent), respectively. In FY2017, expenditures were sustained by the drawdown of prior MIMRA savings. In FY2018, general fund expenditures were cut by $9 million, reflecting the lack of savings to sustain the prior level of expenditures, as use of MIMRA (fishing fee) resources fell by $14 million. While the current level of expenditures can be sustained through the continuing use of abundant fishing revenues, the onset of the Compact Trust Fund era in FY2024 and looming reductions in funding indicate the need for a long-term fiscal strategy. Adjustments due to insufficiency in the Compact Trust Fund are estimated to be about $5 million, or 2 percent of GDP. Potential loss of SEG and other key federal programs under a worst-case scenario represents a further $20 million, or 7 percent of GDP. Using FY2015 as the base before the recent blowout budgets indicates the scope for adjustment. Planned general fund expenditures rose by $20 million over the period FY2015-FY2018. However, the worst-case scenario and need to support the social security system suggest that simply reverting to the FY2015 base may not be sufficient.

COMMITMENT TO REFORM

As there is significant uncertainty on the level of funding post-FY2023, there is thus a need to revisit the reform agenda. Firstly, there is a need to revisit the issue of fiscal responsibility, reverse the recent expansionary budgeted expenditures, allocate resources to the CTF and social security system (SS), and set the nation on a path of long-term fiscal sustainability. Secondly, the reform agenda outlined in the CAP, tax reform, and 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

Favorable Economic Growth Projected

After strong growth in FY2017, the economy in FY2018 is projected to maintain the momentum with continuing growth of 3.7 percent. While the level of use of the infrastructure grant is projected to increase slightly above the FY2017 level, the main impetus for growth comes from the ADB and World Bank projects, although it is still assumed there are considerable capacity limitations. The average GDP growth through the remaining amended Compact is projected at 2.1 percent, above the average growth of 1.7 percent in the first half of the period. The improved performance reflects the boom in donor-funded infrastructure projects. In FY2024, the first year in which the annual grant allocation switches to CTF drawdowns, the economy declines by 0.2 percent, reflecting a reduction in CTF drawdowns to sustainable levels. Thereafter the economy resumes its steady-state growth of 1.3 percent.

GROWING FISCAL IMBALANCE LIKELY

Fiscal projections are made on the basis of the large blowout budget of FY2017 and the budgets of FY2018 and FY2019, which maintain the momentum in spending. In FY2017, the budget incorporated an additional $25 million of general fund expenditures representing a 44 percent increase on FY2016. Not only were MIMRA revenues for the year fully drawn down, but a further $14 million of MIMRA investments were liquidated. The overall result for FY2017 was net domestic financing (NDF; fiscal deficit less debt repayment) of 3.9 percent of GDP. Our projections suggest that in FY2018, NDF will remain positive—that is, indicating a buildup in reserves—but reduced to 0.5 percent of GDP, reflecting the deteriorating fiscal position. Based on an expenditure profile of historical trends in spending patterns, NDF falls through the remainder of the amended Compact to −3.4 percent of GDP by FY2023. The projected fiscal trajectory is clearly untenable, and the
RMI will be forced to adjust over the near term. The FY2017 budget set the stage for a large unsustainable increase in expenditures, and the RMI has failed to adjust back to prior levels.

**FISCAL-RESPONSIBILITY SCENARIO**

Based on prior reform efforts and the Decrement Management Plan, a series of reforms are outlined to restore fiscal balance and responsibility:

- Tax reform
- Expenditure adjustment
- SOE reform and adjustment
- Reduction in Majuro-landowner utility support
- Sustained SS support
- Enhanced CTF contributions

However, the fiscal-responsibility and fiscal reform 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 the RMI is needed if the program is to stand a chance of success.
1. Review of Economic Developments

The RMI economy performed well in FY2017 with 3.6 percent growth in GDP, improving on the 2.0 percent attained in FY2016 and the two previous years of negative growth. During the last two years, the major driver of the improved performance was 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.

- 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 averaged 0.7 percent annually. Since 2010, however, employment levels have remained little changed. Public sector employment has grown by 1.8 percent per annum while private sector employment has fallen by 1.9 percent, offsetting the increase in the public sector.

- Wages have grown modestly in the RMI by 2.5 and 1.4 percent per annum in the private and public sectors, respectively, in the amended Compact since FY2003. However, once inflation has been taken into account, real wages have fallen in the two sectors by 0.2 and 1.3 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. This follows negative inflation of 1.5 and 2.2 percent in the previous two years.

- Between FY1999 and FY2017, real GDP per capita expanded by an average rate of 1.7 percent in each year. In FY2017, gross national disposable income (GNDI) per capita was $6,158, which places the RMI in the World Bank's upper middle-income range from $3,956 to $12,235.
1. Review of Economic Developments

A. Gross Domestic Product, Growth and Structural Change

TRENDS IN ECONOMIC ACTIVITY

Developments in 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). However, the economy stagnated, primarily from the closure of the fish-loining plant and capacity constraints in using additional fiscal resources (see figure 1). 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 3.1 percent in the three years from FY2005 to FY2007.

Contraction in the economy, FY2008-FY2009: By FY2008, the economy had peaked; GDP fell by 2.4 percent. The initial wave of Compact infrastructure-construction projects 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 Marshalls Energy Company (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 a first-ever “state of economic emergency” in late FY2008. In FY2009, while inflation eased back to 0.7 percent and reduced the erosion in household incomes, the same general economic forces exerted themselves and GDP fell again, by a further 1.8 percent.

Economic recovery: During the next four years, FY2010 through FY2013, the economy performed well, averaging 2.5 percent per annum. The main driving force was expansion in the fisheries sector, which contributed 5.1 percent of the overall 14.7 percent growth, with increased output from the reopened loining plant and the addition of new purse seiners to the fishing fleet (see figure 2) for major contributors to economic performance from FY2010 to FY2016). Education and health services also continued to expand throughout this period, contributing 3.2 percent of the total growth. Construction activity was conspicuous in its absence as a driver of growth despite the FAA airport-road realignment project.

Return to growth in FY2016-FY2017: During FY2014–FY2015, economic performance was lackluster, with a contraction of 1.3 percent over the two years largely due to a moratorium placed on disbursements of the Compact infrastructure grant. In FY2016 and FY2017,
economic conditions improved and the economy grew by 1.8 and 4.5 percent, respectively. This reflects a resumption in disbursements of the Compact infrastructure grant, and growth in public services due to the expansionary fiscal policy. Fisheries activity contracted at Pan Pacific in FY2016 because of regulatory issues in conforming to international shipping regulations. While these issues have not been fully resolved, they have been put in abeyance, and fisheries production returned to trend in FY2017. Without the impact of fisheries, GDP in the underlying economy grew by 2.7 and 3.8 percent in FY2016 and FY2017, respectively.

**GDP BY INSTITUTIONAL SECTOR**

**Private sector:** Figure 3 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 2.2 percent since the start of the amended Compact, above the economy-wide average for GDP of 1.6 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, private sector long-term trend growth fell by an average of 0.5 percent. On the other hand, the fisheries sector had trend growth of 8.7 percent.

**State-owned enterprises (SOEs):** 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 fiscus. Figure 4 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 because of the improved financial situation of the MEC, but also other enterprises, including Air Marshall Islands (AMI) and the Ports Authority.

With the deterioration in the financial viability of many SOEs, the need for government subsidy increased. Between FY2003 and FY2006, the annual average level of government subsidy was $3.4 million. However, the level of subsidy is now much higher, averaging $12.6 million per annum during the last three years, FY2015–FY2017. 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 the MEC and the Kwajalein Atoll Joint Utility Resources (KAJUR) during the mid-2000s. While AMI and Tobolar Copra Processing Authority have required an increasing level of support, other SOEs are now also requiring subsidies.
The creation of the Marshall Islands Shipping Corporation (MISC) in FY2007 has required a growing level of subsidy, averaging in excess of $1.8 million during the last two years. The National Telecommunications Authority (NTA) formally returned a positive operating profit, but since the installation of the fiber optic connection it has also required support. The finances of the Marshall Islands Resort (MIR) and Majuro Water and Sewer Co. are also weak. While appearing to operate without subsidy, they receive hidden support through provision of electricity without charge.

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. A special section in the policy chapter of this review provides continuing discussion of the SOE sector and the situation of selected enterprises.

Government: For the national government of the RMI, there have been several phases of growth: a first phase of rapid expansion, between FY2003 and FY2006, fueled by the infusion of funds from the amended Compact, when growth averaged 7.8 percent; a stagnant period, FY2006 through FY2009, as the government adjusted to the fiscal realities following the international financial crisis; and a return to moderate growth, averaging 0.8 percent since FY2009, as fiscal pressure has eased.

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 27 percent of the share of the national government in FY2017 and comprise the CMI and a set of other, smaller entities. The contribution of government agencies has more than doubled since FY2006, with the CMI being the major driving force behind the expansion. The two local governments—Kwajalein Atoll Local Government (KALGOV) and Majuro Atoll Local Government (MALGOV)—represented 22 percent of the size of the national government in FY2017. Their contribution to GDP fell during the period of the international recession, but the level in FY2017 is largely unchanged compared to that at the start of the amended Compact.

Taking government as a whole (RMI government, agencies and local government), there have been three phases (see figure 3): a phase of expansion, when growth averaged 3 percent per annum, reflecting expansion in the RMI government from FY2004 to FY2007; a period of stagnation, from FY2007 to FY2009, which coincided with the international financial crisis; and a third, more recent expansionary phase, since FY2009, averaging 2.3 percent per annum, as all layers of government expanded, but especially the CMI.

Households: 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 changes in the economy: Summarizing the above discussion, changes in the structure of the RMI economy from FY2003 to FY2017 are indicated in Figure 5. Given the recent growth of the fisheries sector, it is not surprising that the share of the private sector has grown from 26.8 percent (FY2003–FY2005 average) to 30.0 percent in the last three years (FY2015–FY2017). 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 36.2 percent to 33.0 percent, a significant reduction. The increasing share of the private sector and reduction in government have been accompanied by a slight increase in the share of SOEs, from 8.3 percent to 8.7 percent, and reduction in indirect taxes, from 11.1 percent to 9.3 percent.

In the case of the SOEs, the increase mirrors the improved performance in many of the entities, although there remains more than substantial room for progress. The drop in the share of indirect taxes reflects the outdated, inefficient nature and lack of buoyancy of the tax regime. The share of the household sector, which represents subsistence and homeownership, has grown, while that of finance (largely banking) has remained unchanged. While there has been an important increase in the share of the private sector, most of this growth occurred in the FY2009–FY2012 period, reflecting the growth in the fisheries sector. Government, on the other hand, after a secular decline in share through FY2013, has risen in the last few years, although not to the level recorded at the start of the amended Compact.

**Conclusion:** During the first 10 years of the amended Compact through FY2013, the private sector displayed an increasing share of GDP, suggesting a switch to private sector growth. This was matched by a significant reduction in the share of government. However, since that time the large increase in natural resource rents has enabled government to resume an upward trend. In the private sector, fisheries have displayed an important upward trend but performance in the rest of the sector has been lackluster. The 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 looms, the boom in fishing fees and aid budgets suggests this might be premature.

**INDUSTRY DEVELOPMENTS**

**Agriculture** consists of 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 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 Marshall Islands Shipping Corporation (MISC), a state-owned enterprise, but this had little impact on production. The producer price of copra, which is set by Tobolar, another SOE, was $240 a short ton between 2003 and 2006 and stood at $592 in 2017—a rate of increase significantly above the consumer price index (CPI). World market prices for copra are volatile and averaged $392 a metric ton between 2003 and 2006. They peaked at $1,157 a metric ton in FY2011 and dropped back to $627 in 2013 but stood at $1,065 in 2017. Tobolar effectively stabilizes the price and receives from the RMI government an annual subsidy, which rose to record highs of $3.4 million and $3.2 million in FY2016 and FY2017, respectively.

The fisheries sector in the RMI economy have been a strong driver of growth, commensurate with the economy's comparative advantage. However, growth has been erratic, reflecting the opening and closure of the PM&O Processing Plant (PMOP) 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 has fallen in most years from this time to 1,907 in 2017. Similarly, the average number of employees recording working at the plant fell from 473 to 137. Operations at the plant are clearly marginal and deteriorating, and the long-run sustainability of the operation must be questioned despite the effective cross-subsidy received from the lower fishing fees paid by PPF.

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 have subsequently commenced operations. 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.

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 seiners by PPF, was a dramatic rise in the contribution of commercial fisheries to the economy during the FY2009–FY2012 period (see figure 6). Value added has risen from an average level of $8.5 million in FY2004 to $17.6 million in FY2017 (constant FY2004 prices). While growth has been strong, the enclave nature of purse-seine operations means linkages to the rest of the economy are limited.

Figure 6 also indicates the growth in fishing royalties received by the RMI primarily from participation in the Parties to the Nauru Agreement (PNA) through the Vessel Day Scheme (VDS). While the value added generated from fisheries is part of GDP, fishing royalties are recorded as a primary income from the rest of the world and form part of gross national income (GNI). While the figure indicates the growth in constant prices for comparison to the fisheries GDP estimate, it indicates the very rapid increase since the initiation of the VDS in FY2010. The floor VDS rate is currently $8,000 per day, but actual negotiated rates stand at over $10,000. The impact of the VDS on the budget and other fisheries-related issues is 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 Majuro Water and Sewer Company (MWSC), the Marshalls Energy Company (MEC), and the Kwajalein Atoll Joint Utility Resources (KAJUR). Trend output of the MWSC has grown during the amended Compact as the capital, Majuro, has expanded. Electricity generation at the MEC has declined because of increasing tariffs, reflecting rising fuel costs, while generation at KAJUR has grown since FY2011.
The construction sector includes private business activities, operations of the Public Works Department (PWD) 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 growth in construction due to the final phase of the FAA airport-realignment project. In FY2014 and FY2015, private sector construction activity reverted to trend, but in the last two years, FY2016 and FY2017, building improved with resolution of compliance issues 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 has oscillated during the amended Compact era, but revealed a slowly growing upward trend. In FY2009, output tanked, reflecting the impact of the recession and rapid inflation. In FY2017, the sector grew strongly with the large fiscal expansion stimulating demand in the economy. The MEC operates a fuel farm and sells fuel to fishing enterprises. Output fell precipitously from FY2006 to FY2007 as the MEC underwent financial collapse. It subsequently improved, reverting to the levels attained at the start of the amended Compact. However, during the last three years the volume of sales contracted as fishing enterprises shifted purchasing to high-seas operators.

The hotel and restaurant sector: Private sector operators suffered a sustained period of decline through FY2011, but this seems to have bottomed out, with some small improvements in the last few years. The Marshall Islands Resort (MIR), an SOE, has managed to increase its share at the expense of other private operators, but output in both the private and SOE sectors has been disappointing, despite the potential of the Marshall Islands as a tourist destination.

The transport and communications sector contains a series of general private sector–operated services and several publicly owned operations. The latter include the Marshall Islands Ports Authority (MIPA), the Marshall Islands Shipping Corporation (MISC), Air Marshall Islands (AMI) and the National Telecommunications Authority (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 FY2011, output has improved.

Financial intermediation, primarily the banking sector, has performed well during the amended Compact, growing by an annual average rate of 4.0 percent. In FY2011 and FY2012, output stagnated, reflecting the large payouts to Kwajalein landowners and reductions in deposits and repayment of loans. However, output has resumed its upward path in the three years since FY2013.

Other private services: Ownership of dwellings has risen during the amended Compact, reflecting an assumed rate of growth of the population. Business services have been largely stagnant, but with a downward trend since FY2011. Although a relatively minor activity, private personal services have been buoyant.

Public administration: Comprising the national government, agencies and local government, public administration has expanded modestly during the amended Compact, by an average trend rate of growth of 1.0 percent, although as noted above this reflects periods of varying performance.

Education: Private education has grown continuously during the amended Compact period, by a trend average of 1.5 percent per annum, reflecting the switch in Compact assistance to the sector-grant approach. The CMI resumed growth once the accreditation problems were resolved and has expanded rapidly, averaging 6.4 percent during the amended Compact.

Health services have grown by an average trend of 1.1 percent during the amended Compact, again reflecting the emphasis on health care during the amended Compact.

Conclusion: To conclude this section, figure 7 summarizes and indicates the major drivers of the RMI economy during the amended Compact period. The economy grew by a total of 26.3 percent, or by an annual average
rate of growth of 1.7 percent. The combined activities of public administration, education and health were responsible for 11.1 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 6.1 percent, or 23 percent of the total growth. However, while the impact of the loining plant has been significant, 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 stagnated 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 coming years. Other private sector activities have remained little changed. 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** in the RMI has historically grown at very high rates. 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**: Limited job opportunities and the depressed state of the economy during the latter 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.

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

GDP and GNDI per capita: Figure 8 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 US 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 FY2017, GNDI per capita was $6,158, which is 61 percent higher than the current-price GDP per capita of $3,822.

GDP PER CAPITA: REAL INCOMES

GDP and GNDI per capita: Figure 8 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 low levels of net aid transfers depleted by the need to repay the former extravagances. In

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

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

Source: Census reports
1999, matters improved, as fiscal stability was restored with new donor assistance, repayment of the debt and a favorable financial outcome of the amended Compact negotiations. Between FY1999 and FY2017, real GDP per capita expanded by an average rate of 1.7 percent in each year, surpassing the level achieved in the mid-1990s for the first time. 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 FY2017 GDP per capita had regained much of the lost ground, attaining the level attained 21 years before in FY1995.

DISTRIBUTION AND POVERTY

Poverty and hardship: While this review is macroeconomic in nature, it is useful to comment on poverty and income-distribution issues. Drawing on discussions raised in the ADB’s 2002 Assessment of Hardship and Poverty and its 2005 Social and Economic Report, and the more recently completed 2009 National Millennium Development Goals (MDG) Progress Report, prepared by the United Nations Development Program (UNDP/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.

Geographical distribution: According to 2011 census data, 41 percent of outer-islanders have an income of less than a dollar a day (in 2011 prices). Figure 9 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 production compensates for the lack of cash income, and the emerging picture of income distribution
C. Employment, Earnings and Wages

EMPLOYMENT

Figure 10 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 reflection of trends.

Employment in the private sector: At the start of the amended Compact in FY2005, employment in the private sector fell by 14 percent (579 employees) with the closure of the PMOP loining plant to a level of 3,626. 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 FY2017, and the daily average fell to 137. 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 1.6 percent over the last six years, although there was some pickup in the last two years with resumed construction activity.

Employment in the public sector: From a 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 30 percent between FY1999 and FY2007, at an annual average rate of 3.3 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 FY2016.

**Overall trends in employment:** Figure 11 shows the overall rate of job creation during the amended Compact from all institutional sectors, including the US military base at Kwajalein. In FY2005, the closure of the PMOP loining plant led to substantial layoffs. In FY2008 and FY2009, retrenchment at the military base and declines in construction output offset the reopening of the loining plant, and employment fell by 0.3 percent in each of the two years. However, in FY2010, significant growth in employment at the plant compensated for the declines in the prior two years, despite continuing layoffs at Kwajalein and reductions in construction; overall employment growth expanded by 5.2 percent. However, the growth in employment at the plant was short lived and has trended downward ever since. While employment at the military base has stabilized, the declines at the plant have offset the growth in the public sector and overall employment levels declined though FY2015. In FY2016 and FY2017, employment improved and grew by 2.5 and 1.0 percent, respectively, reflecting the general growth in the economy.

**Employment structure:** Figure 12 indicates the structure of nongovernment employment, excluding public administration, education and health. The wholesale and retail trade 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 (7 percent), hotels and restaurants (5 percent) and construction (10 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 (15 percent). Employment at the base was projected to fall by 669 jobs out of a total of 1,236 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 240.

**WAGE RATES**

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 13 reveals a series of interesting trends. First, private and public sector wages have grown over the period by 2.5 percent and 1.4 percent, respectively. However, real wages (i.e., discounting for the impact of inflation) have fallen by 0.2 percent and 1.3 percent, respectively. The difference between
the nominal and real series is 2.7 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 13, 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 124 percent in FY2003 to 93 percent in FY2017, which is a move in the right direction.

D. Prices

Accelerating inflation in FY2008: Figure 14 indicates trends in the 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.

Moderation and falling price levels: In FY2009, fuel prices moderated significantly to levels below those of FY2008, while food prices followed suit, falling in the subsequent year. Overall inflation was 0.5 percent in FY2009 and 1.8 percent in FY2010. 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 fuel prices, inflation turned negative and fell by 2.2 percent in FY2015, 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. By FY2017, nearly all prior price changes had stabilized and the CPI recorded no change.
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, recent fishing-fee royalties and current Compact and other aid transfers. The balance on current account averaged a positive 1 percent of GDP during the amended Compact and was largely in balance apart from exceptional years. In the last three years, the significant reduction in fuel prices has been associated with a positive outcome on 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 a level of 72 percent of GDP at the start of the amended Compact to 35 percent in FY2017.

- 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 ADB and is no longer eligible for concessionary-loan finance. This has both benefits and costs, but 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 went largely unchanged, but with significant increase in inflation in the RMI due to rising fuel and food prices, the real effective exchange rate (REER) spiked in FY2008, resulting in a loss of competitiveness. The REER has subsequently depreciated, but has not adjusted downward to its prior level.
A. Balance of Payments

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. The trade account consists of imports and exports. 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 FY2017. In FY2016, Pan Pacific underwent regulatory issues in conforming to international shipping regulations, but these have been put in abeyance, allowing production to return to former levels while suitable measures to ensure compliance are put in place.

Imports: free-on-board (f.o.b.) less re-exports of fuel (retained imports) have maintained a relatively stable share in relation to GDP after accounting for exceptional items and fuel-price changes. Through FY2009, imports averaged close to 43 percent of GDP. FY2010 was an exceptional year, when retained imports/GDP rose to 60 percent because of an increase in imports of purse-seine fishing vessels by Pan Pacific. In the remaining period through FY2017, retained imports averaged 48 percent of GDP. The economy thus appears to have been more import dependent in recent years, but without greater product detail on the composition of imports it is difficult to analyze causes.

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 service 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; and a variety of service exports, including port facilities, telecommunications and others. In total, these flows were static during the first three years of the amended Compact but showed signs of growth from FY2008 through FY2014. In the last three years, exports of fish-trans-shipment services have fallen, reversing the prior upward trend in service exports. 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. Overall payments for services have displayed a gradual upward trend.

Primary income receipts: 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 is now close to 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 ship and corporate registry, collected by the Trust Company of the Marshall Islands (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 tightly 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-license fees have grown rapidly in recent years as a result of the implementation of the Parties to the Nauru Agreement (PNA) and operation of the Vessel Day Scheme (VDS). Through FY2010, fishing royalties averaged $2.7 million, but they grew rapidly to $24.3 million in FY2015 and have stabilized at that level in the last two years. Further rapid growth in fish royalties is not anticipated, and it is expected that receipts will gradually grow over time.

### Table 3 Balance of payments, current account, FY2010-FY2017

<table>
<thead>
<tr>
<th>[US$ millions]</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
<th>FY14</th>
<th>FY15</th>
<th>FY16</th>
<th>FY17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account balance</td>
<td>-30.1</td>
<td>-3.9</td>
<td>-11.8</td>
<td>-20.7</td>
<td>-3.2</td>
<td>26.1</td>
<td>19.2</td>
<td>10.0</td>
</tr>
<tr>
<td>Goods and services balance</td>
<td>-124.0</td>
<td>-99.8</td>
<td>-99.2</td>
<td>-119.3</td>
<td>-108.2</td>
<td>-101.7</td>
<td>-104.9</td>
<td>-117.0</td>
</tr>
<tr>
<td>Goods balance</td>
<td>-90.9</td>
<td>-64.5</td>
<td>-60.7</td>
<td>-78.0</td>
<td>-72.8</td>
<td>-65.7</td>
<td>-67.4</td>
<td>-71.8</td>
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<tr>
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<td>21.7</td>
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<td>60.9</td>
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<td>66.4</td>
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<td>23.5</td>
<td>25.2</td>
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<td>College of Marshall Islands</td>
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<td>5.9</td>
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<td>Other 2/</td>
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<td>6.9</td>
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<td>7.6</td>
<td>8.5</td>
<td>9.2</td>
<td>9.5</td>
<td>10.5</td>
<td>11.2</td>
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</tbody>
</table>

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
Dividends and interest are an important source of earnings and predominantly represent earnings from the nuclear-related trust funds, overseas earnings of local construction companies, and earnings of MIFCO, the local purse-seine joint venture (treated as nonresident).

**Primary income payments:** On the payments side, dividends paid by foreign direct investment (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 in FY2016 and FY2017 as prices firmed. Other payments of primary incomes are represented by interest payments on external debt and Compact rent payments to Kwajalein nonresident landowners living in the US.

**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.

Remittance outflows are mainly household transfers and are estimated to be larger than inward remittances from Marshallese living in the US. 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.

**Capital account:** 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. 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 project-management issues have been resolved. Use of funds grew in FY2017 and will be fully utilized in FY2018. “Other” capital grants, which include FAA grants to the Ports Authority for airport improvements, rose significantly.

### Table 4 Balance of payments, capital and finance accounts, FY2010-FY2017

<table>
<thead>
<tr>
<th>(US$ millions)</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
<th>FY14</th>
<th>FY15</th>
<th>FY16</th>
<th>FY17</th>
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<td>8.5</td>
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<tr>
<td>Capital inflows</td>
<td>18.6</td>
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<td>9.6</td>
<td>15.9</td>
<td>9.6</td>
<td>8.5</td>
<td>10.9</td>
<td>9.8</td>
</tr>
<tr>
<td>National gov’t, Compact capital grants</td>
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<td>12.0</td>
<td>5.4</td>
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<td>1.9</td>
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<td>8.3</td>
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<td>5.8</td>
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<td>1.0</td>
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<td>0.0</td>
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<tr>
<td>Net lending/borrowing (current + capital)</td>
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<td>10.6</td>
<td>-3.2</td>
<td>-4.8</td>
<td>6.4</td>
<td>34.6</td>
<td>30.1</td>
<td>19.7</td>
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<td>-4.5</td>
<td>-10.1</td>
<td>-12.5</td>
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<td>4.2</td>
<td>3.3</td>
<td>4.8</td>
<td>5.8</td>
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<tr>
<td>Portfolio investment (increase in assets: -)</td>
<td>7.3</td>
<td>15.3</td>
<td>6.9</td>
<td>10.6</td>
<td>16.9</td>
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<td>9.2</td>
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<td>~</td>
<td>~</td>
<td>~</td>
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<td>Liabilities</td>
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<td>0.4</td>
<td>-1.3</td>
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<tr>
<td>Other investment (increase in assets: -)</td>
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<td>-2.4</td>
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<td>-15.4</td>
<td>-28.1</td>
<td>-32.5</td>
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<td>-12.2</td>
<td>-22.9</td>
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<td>-20.3</td>
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<tr>
<td>Liabilities (public sector loans)</td>
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<td>-4.2</td>
<td>1.7</td>
<td>-3.2</td>
<td>-5.2</td>
<td>-4.7</td>
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</tbody>
</table>

2/ Coverage of nuclear-related trust funds is incomplete.
in FY2013, reflecting the Majuro-airport-realignment project, and offset the decline in infrastructure-grant disbursements. This item is anticipated to grow strongly in the future with the large increase in grants from the World Bank and the ADB.

**Financing**: 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-joining plant and investment in three purse seiners by PPF. Portfolio investment includes a series of important items. (Note that increases in assets are shown as negative in the BoP, while increases in liabilities are positive.) First, the US paid sizeable reparations and funds for relocation to the islanders of Bikini, Enewatok, Utirik 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 Marshall Islands Social Security Administration (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. The outturn was positive in FY2017, reflecting strong market performance. Reforms have now been put in place to reverse the deterioration, and this is an issue taken up in the policy section of the review. Other investments include changes in commercial bank foreign assets, which have generally shown a significant increase, reflecting deposit growth. In FY2012 and FY2013, with the Kwajalein landowner rent payout, deposits and commercial bank foreign assets fell. Other investment liabilities reflect drawdowns and repayments on external debt.

**Overall trends in the balance of payments**: The structure and current trends in the BoP are displayed in figure 15. 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 1 percent of GDP during the amended Compact and was largely in balance apart from exceptional years. In the last three years, the significant reduction in fuel prices has been associated with a positive outcome on current account, although the terms-of-trade improvements are on the wane.

**Errors and omissions**: Overall, errors and omissions (the difference between net lending and the financing account) have averaged $20 million during the FY2010–FY2017 period, or 8 percent of goods and services. Clearly, there is a consistent negative bias and error in the balance of payments of a non-negligible amount reflecting that a variety of flows are not known with precision.

**Figure 15**
Balance of payments current account: percent GDP

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**B. Gross National Disposable Income**

The availability of BoP estimates enables us to generate gross national income (GNI) and gross national disposable income (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 32 percent and 61 percent higher than GDP in FY2017, 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 16. Both the primary and secondary incomes of the BoP have been deflated by a composite index of the CPI and GDP deflator. Figure 17 provides a description of the trends in GDP, GNI and GNDI from FY2004 through FY2017.

Developments in primary incomes: The main determinants of primary incomes are compensation of employees at the Kwajalein base, rent received by the Kwajalein landowners, fishing-fee royalty, 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, and compensation of employees fell, although it has since regained its 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 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. After these data, fishing royalties reached a plateau and the increase in primary incomes came to a halt.

Developments in secondary incomes: In the case of secondary incomes, the current-price 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. Translating into constant prices, secondary incomes rose through FY2006, subsequently declined, rose in FY2015 with negative inflation, and stabilized in the last two years.

During the amended Compact period, GDP averaged an annual rate of growth of 1.7 percent. The impact of overall declining real primary incomes and a subsequent rise after FY2012 resulted in real GNI achieving the same rate of growth as GDP. Given the deterioration in the level of secondary incomes after FY2007, GNDI averaged out at the same rate of 1.5 percent of GDP. Looking forward, it is not expected that fishing royalties will rise further...
and instead will stabilize at about current levels in real terms. On the other hand, 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 nominal effective exchange rate (NEER) is a trade-weighted index of the exchange rates representing currencies of countries with which the RMI engages in trade in goods and services. 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 US, the US dollar dominates and accounts for 63 percent of international trade. Considering that the RMI uses the US 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 18 indicates that the NEER depreciated during the first nine years of the amended Compact, reflecting the depreciation of the US dollar, gained strength as the US dollar strengthened in subsequent years, but has weakened slightly since the start of 2016.

The real effective exchange rate (REER) is a measure similar to the NEER, but currency movements are adjusted for changes in the CPI of the respective country. It is thus a proxy for the 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, resulting in a loss of competitiveness. 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 US dollar and a higher rate of inflation in the RMI compared with the RMI’s trading partners. During 2016, the US dollar started to depreciate, and, coupled with the negative inflation in the RMI, the real exchange rate depreciated.

In some measures of the REER, currency movements are adjusted by relative movements in wages. As discussed above, nominal wages have grown modestly, and real wages have fallen. It is thus likely that the REER based on CPIs overstates the loss of competitiveness. However, the large rise in fuel prices from a subsidized level at the start of the amended Compact affected all agents and pushed up the cost of doing business in the RMI. The pattern emerging is that the RMI lost competitiveness during the financial crisis; after a brief period of improvement, the REER again appreciated, but has weakened during the last two years.

D. External Debt

ADB debt: During Compact I, the government developed a substantial portfolio of loans from the Asian Development Bank (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 FY2017 was $54.1 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 those through the Public Sector Program, 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.

**RUS debt**: Other major external-debt commitments represent government-guaranteed debt to the SOE sector and liabilities owed to the Rural Utilities Service (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 for the NTA, which was extended by another $4 million in 1993. In 1997, the MEC secured an RUS loan for $12.5 million to finance the new power plant on Majuro. 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 all cases of default by the SOEs, with the exception of the recent RUS extension, the RMI must meet debt-service requirements.

**Grant-only status**: Figure 19 shows the substantial size of the RMI’s external debt and the burden of the debt servicing from FY2004 to FY2017. In FY2003, the level of outstanding debt was $94 million (71 percent of GDP). External debt recorded a level of $78 million at the end of FY2017, but as a percentage of GDP, it declined to 37 percent. While most of the debt is on concessional terms, the level of debt remains substantial and above the 30 percent threshold that qualifies the RMI as being at high risk from "debt stress" according to the IMF debt-sustainability analysis (DSA). As a result, the World Bank has declared the RMI as eligible for grant-only finance and no longer eligible for external borrowing. This will ensure that the RMI’s debt profile will continue to improve. Debt service has increased from $4.3 million to $7.9 million but fallen from 14 percent to 10 percent of general fund revenues, below the IMF threshold of 18 percent.

**Debt levels and servicing**: The RMI debt profile as a percentage of GDP has improved significantly during the amended Compact, resulting from restraint on new borrowing and growth in nominal GDP. However, the external

<table>
<thead>
<tr>
<th>Loan</th>
<th>Number</th>
<th>Year</th>
<th>Original debt, (US$ millions)</th>
<th>Estimated outstanding principal September 2016, (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ebeye Fisheries Loan</td>
<td>1102-MAR (SF)</td>
<td>1992</td>
<td>3.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Emergency Rehabilitation Loan (Typhoon Gay)</td>
<td>1218 MAR (SF)</td>
<td>1993</td>
<td>0.5</td>
<td>0.3</td>
</tr>
<tr>
<td>Basic Education Project Loan</td>
<td>1249 MAR (SF)</td>
<td>1993</td>
<td>8.4</td>
<td>5.1</td>
</tr>
<tr>
<td>Majuro Water Supply Project Loan No. 1</td>
<td>1250 MAR (SF)</td>
<td>1993</td>
<td>0.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Majuro Water Supply Project Loan No. 2</td>
<td>1389-RMI (SF)</td>
<td>1995</td>
<td>8.4</td>
<td>6.0</td>
</tr>
<tr>
<td>Health and Population Project Loan</td>
<td>1314-RMI (SF)</td>
<td>1995</td>
<td>5.9</td>
<td>3.6</td>
</tr>
<tr>
<td>Public Sector Reform Program</td>
<td>1513-RMI (SF)</td>
<td>1997</td>
<td>12.0</td>
<td>8.8</td>
</tr>
<tr>
<td>Ebeye Health and Infrastructure</td>
<td>1694-RMI (SF)</td>
<td>1999</td>
<td>9.3</td>
<td>5.2</td>
</tr>
<tr>
<td>Skills Training and Vocational Education Project Loan</td>
<td>1791-RMI (SF)</td>
<td>2001</td>
<td>7.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Fiscal and Financial Management Program Loan</td>
<td>1829-RMI (SF)</td>
<td>2001</td>
<td>8.0</td>
<td>4.2</td>
</tr>
<tr>
<td>Outer-Islands Transport and Infrastructure Loan</td>
<td>1948-RMI (SF)</td>
<td>2003</td>
<td>7.9</td>
<td>0.4</td>
</tr>
<tr>
<td>Public Sector Program</td>
<td>2659-RMI (SF)</td>
<td>2010</td>
<td>10.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Public Sector Program</td>
<td>2950-RMI (SF)</td>
<td>2013</td>
<td>4.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Marshalls Energy Company - New Powerplant Loan</td>
<td>1997</td>
<td></td>
<td>12.5</td>
<td>2.4</td>
</tr>
<tr>
<td>NTA Loan</td>
<td>1989, 1993, 2009</td>
<td></td>
<td>41.3</td>
<td>21.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>140.9</strong></td>
<td><strong>77.9</strong></td>
</tr>
</tbody>
</table>
debt-service picture has presented a different picture. While much debt is on concessional terms, there has been a substantial rise in debt service on the government’s portion of the debt, as grace periods of prior loans have expired. External-debt servicing is funded through the general fund or government’s discretionary resources, and the RMI has gone through periods of significant debt stress. While it is currently less of a key fiscal issue, it requires careful monitoring.

E. Debt Management

**SOE debt projections:** There are two main components of debt service: government debt on concessional terms to the ADB, and government-guaranteed debt incurred by the SOE sector. Figure 20 indicates the projected trend in debt service for the two types. External debt of the SOEs is at higher interest rates and shorter terms and thus incurs a proportionately higher service commitment. Debt service of the NTA and MEC is projected in FY2018 to be $2.6 million and $1.2 million, respectively. SOE debt service is projected to fall to $2.8 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 due for liquidation.

**NTA debt:** It was recognized in FY2009 that the financing of the new fiber optic cable through extension of the existing Rural Utilities Service (RUS) facility would place the NTA in a negative income position. However, it was felt that benefits to the RMI economy and communities of 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 owing.

**ADB debt projections:** For debt to the ADB, the government will be required to set aside on average $3.8 million, maxing 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 3.8 percent of the $82 million of general fund revenues in FY2017. In earlier years, nearly all of the RMI debt was in grace period, and debt-service obligations were not significant. However, in recent years, principal repayments for many of the loans have fallen due, and debt service has contributed at times to significant fiscal pressure. The increase in debt service in FY2019 represents the first repayments of the Public Sector Program (PSP) loan, and the drop in FY2020 signifies completion of repayment of 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.

**Debt-management performance:** 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. Further, the failure to make regular subsidies to the NTA for debt service of the fiber optic commitment was a weak spot. The debt-service crisis brought home the impact of a poorly managed external-debt strategy.

**Limitations of grant-only status:** As a result of the IMF/World Bank’s debt-sustainability analysis (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 the agencies. 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 $30 million a year, or 15 percent of GDP) suggests this might not be an issue if the RMI is able to channel the funds into priorities of its choosing.

**Debt-management strategy:** The need for a well-articulated debt-management strategy to assist the RMI in maintaining debt at prudent levels may thus 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 proceed with implementation of a debt-management strategy to enable determination of the type of projects for which external-loan finance is appropriate and the capacity 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

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**Table 6** Marshall Islands: International investment position, FY2010-FY2017

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

1/ Coverage of local government trust funds is incomplete.
2/ At banks abroad
reforms, the timing might be appropriate to reconsider the former bill.

F. International Investment Position

The RMI international investment position (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 nuclear-related trust funds held by local governments, which have not been audited for some years, although efforts to improve the absence of information are ongoing. However, 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).

The Social Security Administration is the other major holder of portfolio investments and has experienced similar forces to the nuclear funds, but declined in FY2013-FY2016, reflecting the underlying deterioration in the financial position of the system. In FY2017, Social Security 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 $136 million at the end of FY2017. 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. For FY2016 and FY2017, with additional accountants recruited, the audit was completed on time.

- The RMI achieved a large fiscal surplus in FY2017 of 4.3 percent of GDP, the third year in a row of strong performance. Revenues grew strongly, reflecting very 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 three 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 gross receipts tax (GRT) and customs duties. Overall, the RMI tax regime is in need of reform and displays a lack of buoyancy and fails to provide a growing source of revenues over time.
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).

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 US 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 US 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)

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual sector grants</th>
<th>Ebeye special community needs</th>
<th>Ebeye community landowners</th>
<th>Ebeye environmental impact</th>
<th>Audit</th>
<th>Kwajalein impact (landowners)</th>
<th>Trust fund contribution</th>
<th>Total contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY04</td>
<td>30.0</td>
<td>3.1</td>
<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>15.0</td>
<td>7.0</td>
<td>57.7</td>
</tr>
<tr>
<td>FY05</td>
<td>29.5</td>
<td>3.1</td>
<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>15.0</td>
<td>7.5</td>
<td>57.7</td>
</tr>
<tr>
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<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>15.0</td>
<td>8.0</td>
<td>57.7</td>
</tr>
<tr>
<td>FY07</td>
<td>28.5</td>
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<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>15.0</td>
<td>8.5</td>
<td>57.7</td>
</tr>
<tr>
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<td>28.0</td>
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<td>1.9</td>
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<td>0.5</td>
<td>15.0</td>
<td>9.0</td>
<td>57.7</td>
</tr>
<tr>
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<td>1.9</td>
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<td>0.5</td>
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<td>10.0</td>
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<td>0.2</td>
<td>0.5</td>
<td>15.0</td>
<td>10.5</td>
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</tr>
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<td>0.5</td>
<td>15.0</td>
<td>11.0</td>
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<tr>
<td>FY13</td>
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<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>15.0</td>
<td>11.5</td>
<td>57.7</td>
</tr>
<tr>
<td>FY14</td>
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<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>18.0</td>
<td>12.0</td>
<td>62.7</td>
</tr>
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<td>1.9</td>
<td>0.2</td>
<td>0.5</td>
<td>18.0</td>
<td>12.5</td>
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<td>0.5</td>
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A. The Fiscal Framework

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 US 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.

Joint Economic Management and Financial Accountability Committee: The annual budget allocations are awarded through the Joint Economic Management and Financial Accountability Committee (JEMFAC). The US 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 US 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 US on a 3–2 basis, JEMFAC resolutions must be agreed on by consensus. Of course, since the US 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 US has outright control over them.

Infrastructure requirements: A special condition agreed upon by both parties is that the RMI will devote between 30 percent 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 FY2017, 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 Supplemental Education Grant (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. In FY2017, the audit reports a use of resources of $5.3 million. 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 Republic of China (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 fiscal policy makers.

The structure of government: Government in the RMI consists of the national government; the urban local governments of Majuro Atoll Local Government (MALGOV) and Kwajalein Atoll Local Government (KALGOV); the nuclear-affected-atoll local governments of Bikini, Ronelap, 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. For FY2016 and FY2017, with additional accountants recruited, the audit was completed on time. In this chapter of the review, discussion will focus on fiscal developments during the FY2004–FY2017 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, 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 three fiscal periods, FY2015 through FY2017. Figure 21 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 further expansion. While a deficit of 1.6 percent of GDP was recorded in the first year of

Figure 21
RMI consolidated revenues and expenditures, FY2004–FY2017
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 2.8 percent per annum, reflecting a weak tax regime. The gross receipts tax and customs duties 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 Vessel Day Scheme (VDS) in FY2010, which initiated a rapid rise in revenue growth.

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 1.6 percent of GDP.

**Rapid fiscal expansion, FY2015-FY2017:** During the last three years, FY2015 through FY2017, the fiscal situation entered a new era after a period of stagnant revenues; the outlook shifted into high gear. Overall revenue growth expanded by 14 percent per annum, with all categories showing buoyancy. Tax revenues grew by 8 percent per annum with the wages tax and customs duties showing solid performance, although the gross receipts tax was flat. Revenues from 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 million to $40 million during this period, although the FY2017 level was exceptional because of receipts of earlier fishing fees from MIMRA.

2. 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 three years, payroll expense grew by 4.4 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 8.8 percent per annum, and subsidies by a massive 36 percent. “Other” expense and transfers to government agencies also expanded strongly by nearly 30 percent each. 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 3.8 percent of GDP.

**THE FISCAL STRUCTURE**

**Grants:** Figure 22 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 22, grants as a percentage of GDP rose to 45 percent in FY2007 but have slowly declined since that time, falling to 31 percent in FY2017. 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, there has been some increase in the tax/GDP ratio, but it reflects increased earnings from the ship and corporate registry rather than any changes in the tax regime. Trends in tax effort during the amended Compact (excepting fees for ship and corporate registry) 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, which have risen from less than 1 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 three 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 $14.8 million, or 40 percent, of a total tax yield of $37.1 million in FY2017. 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 0.84 to the tax base of compensation of employees. That is, for every additional percentage-point increase in wages, taxes only rise by 0.84 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 gross receipts tax** (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. Estimates of the GRT buoyancy, the ratio of GRT collections to value added in industries generating GRT, indicate a ratio of 1.01. This shows that although the tax has many undesirable properties, it has provided government with an elastic source of revenue, at least in comparison with the other major tax sources.

**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 have performed weakly since that time, reflecting the effects of special exemptions and reductions in taxes on basic items. 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 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 balance of payments, indicate a ratio of −0.12; 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 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. 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 Inc. (IRI), have enabled growth from this source, which yielded $7.3 million in FY2017. The basis of estimation determined by IRI 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.

Of nontax revenues, fishing fees raised an average of $1.3 million during the FY2004–FY2009 period but were a volatile source, depending on the location of the fishing stock. Since FY2010, with the implementation of the Vessel Day Scheme (VDS) under the Parties to the Nauru Agreement (PNA), fishing fees have been very buoyant, and the government received $40.0 million in FY2017. 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 23. Payroll costs grew rapidly at the start of the amended Compact, moderated in the fiscal-consolidation period, and picked up speed in FY2017. 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 4.5 percent per annum. After FY2006, as expenditures hit their ceilings, only modest growth in payroll was possible, averaging 1.7 percent per annum between FY2006 and FY2016. With the large increase in resources in the budget in FY2017, payroll grew by 8.2 percent, the largest rise since FY2005. The downturn in FY2007 reflects the creation of the Marshall Islands Shipping Corporation (MISC), whose function was previously executed through the Ministry of Transport and Communications (MOTC). Wages and other costs of the MOTC are thus now funded out of a subsidy to the MISC.

Figure 23
Expenditures on payroll and goods and services, FY2004–FY2017

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<th>Year</th>
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<th>Goods and Services</th>
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</tr>
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<tr>
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Goods and services: The trend in outlays on goods and services has been more erratic, but strongly associated with the fiscal envelope. Outlays expanded during the initial years of the amended Compact, 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. Use of goods and services contracted in FY2014 as revenues tightened, but grew strongly in FY2016 and FY2017, reflecting the large increase in resource availability. While maintaining payroll but cutting other costs may keep expenditures within budget 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: The level of current subsidy to the public-enterprise sector has increased significantly during the amended Compact (see figure 24). The level of subsidy averaged $3.2 million from FY2004 to FY2006 and plateaued at an average of $7.7 million between FY2007 and FY2014. During the last three years, there has been a marked increase in subsidies, attaining 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 $11.6 million, but like all other elements of expense rose dramatically during the last three years, attaining $29.0 million in FY2017.

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. 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: The financing account in the RMI in general displays few discernable trends. The small overall fiscal surplus/deficit, averaging $1.5 million during the FY2004–FY2013 period, has been financed through a 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 and 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 built up foreign deposits.

1 FY2005 excluded because of a large capital transfer to the CTF.
Financing in FY2011 was a special case:
Analysis of the finance account in FY2011, when several large and important transactions occurred, warrants special explanation. In FY2011, the government on-lent the proceeds of the ADB public sector loan ($9 million) to the MEC to refinance a former Bank of Guam loan. This transaction is shown as an increase in foreign liabilities (incurrence of external debt from the ADB), with a matching increase in domestic assets (loan to the MEC), where accumulation of assets is shown as a negative in the GFS. In FY2011, the Kwajalein landowners came to an agreement with the US on landowner rent payments. Previous Compact receipts under this item had been held by the RMI government in escrow until a settlement with the US was reached. During FY2011, there was a large payout to landowners, and this was represented by a decrease of $24 million in government foreign currency deposits and a matching reduction in liabilities recorded under domestic accounts payable. There were a number of other financial transactions in FY2011, but these were minor.
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 US 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 roadmap for 2014–16. The PEFA roadmap 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 Comprehensive Adjustment Program (CAP), the Tax and Revenue Reforms and more recently the Decrement Management Plan (DMP). However, all of these efforts have so far failed to come to fruition.
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 US under the sector grants. Implementing public financial management (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. Reflecting a PFM approach to budgeting in the Compact and consisting of both an MTFF and MTEF, the RMI system was termed the Medium-Term Budget and Investment Framework (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.

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 Economic Policy, Planning, and Statistics Office (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 US 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.

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.
PFTAC and revenue forecasting: In 2017, the PFTAC provided assistance to the RMI to improve the medium-term 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 Macroeconomic and Fiscal Forecasting Framework (MFFF). Government revenues were forecast in relation to the projections of the MFFF, 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 proved hard to achieve. The ADB has initiated $2 million of technical assistance (TA) to support PFM and capacity building in the ministry. Bank reconciliations and audits are now timely, and hopefully this will encourage a more permanent capacity.

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 more 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 there is discussion of preparing a follow-on framework. However, before it is updated a critical review of the plan is required so that future editions may provide the

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1 See chapter 9, “Long-Term Economic Outlook.”
type of planning document needed as the basis for long-term planning and an anchor to the medium-term budgeting exercise.

PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY (PEFA)

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 public financial management (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. 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.

Roadmap 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 “roadmap.” In collaboration with the government, the PFTAC prepared a roadmap for 2014–16, which was endorsed by the cabinet in August 2014. The PEFA roadmap 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 PEFA provides the main assessment method of PFM performance, the Graduate School has provided a related measure of financial performance known as the performeter.1 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 percent 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 of revenues 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 has shown significant improvement, reflecting growth in fishing-fee incomes. Tax effort is

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

**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 49 percent to 30 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 percent 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, although this may overstate capital-asset condition, given the precarious state of the government complex.

Liquidity is measured by two measures: the ratios of current assets to liabilities (scored on the interval 0 to 200 percent) and 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 25. The results indicate that the RMI score has improved significantly during the amended Compact, rising from a score of 38 in FY2004 to 61 in FY2017. 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 a largely an accounting measure of financial health, the results clearly indicate that the RMI has made significant progress.

## 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 26 indicates recent trends in the number of civil servants and payroll costs. The number of civil servants increased from 1,892 in FY2003 to 2,563 in FY2018, an annual rate of 2.0 percent. Payroll costs rose at an average rate of 3.9 percent over the period. These trends have been influenced by a number of extraordinary items that require incorporation into the analysis.

**Payroll in Ministry of Education:** A significant portion of the growth in the payroll cost and in employee numbers has been in the Ministry of Education (MOE). In FY2003, employment at the MOE was 706, and it expanded to 1,136 by FY2018. 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 FY2003–FY2018 period was 230 positions, or an annual average increase of 1.9 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 in Ministries of Health and Transportation:** Substantial growth in payroll has come from outside the MOE. Employment in the Ministry of Health (MOH) increased by 121 positions, from 437 in FY2003 to 558 in FY2018 (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 (MOPW) were scaled back in the late 1990s.

![Figure 25](image)

**Figure 25**
Overall fiscal performance (score out of 1-100), FY2004-FY2017

<table>
<thead>
<tr>
<th>Department</th>
<th>FY03</th>
<th>FY04</th>
<th>FY06</th>
<th>FY08</th>
<th>FY10</th>
<th>FY12</th>
<th>FY14</th>
<th>FY16</th>
<th>FY18</th>
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<tr>
<td>President &amp; Cabinet</td>
<td>23</td>
<td>22</td>
<td>27</td>
<td>33</td>
<td>28</td>
<td>26</td>
<td>26</td>
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<tr>
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<td>18</td>
<td>21</td>
<td>25</td>
<td>34</td>
<td>24</td>
<td>28</td>
<td>24</td>
<td>27</td>
</tr>
<tr>
<td>Special Appropriations</td>
<td>2</td>
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<td>0</td>
<td>10</td>
<td>0</td>
<td>0</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Council of Iroij</td>
<td>14</td>
<td>15</td>
<td>16</td>
<td>15</td>
<td>16</td>
<td>17</td>
<td>18</td>
<td>17</td>
<td>18</td>
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<tr>
<td>Nitijela</td>
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<td>42</td>
<td>48</td>
<td>50</td>
<td>50</td>
<td>49</td>
<td>47</td>
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<td>26</td>
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<tr>
<td>Ministry of Education</td>
<td>706</td>
<td>720</td>
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<td>1,067</td>
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<td>1,136</td>
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<tr>
<td>Health &amp; Environment</td>
<td>437</td>
<td>480</td>
<td>535</td>
<td>529</td>
<td>513</td>
<td>531</td>
<td>532</td>
<td>526</td>
<td>558</td>
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<tr>
<td>Transport &amp; Communications</td>
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<td>108</td>
<td>100</td>
<td>18</td>
<td>17</td>
<td>19</td>
<td>18</td>
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<tr>
<td>R &amp; D</td>
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<td>27</td>
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<td>34</td>
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<td>Internal Affairs</td>
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<td>64</td>
<td>102</td>
<td>94</td>
<td>92</td>
<td>81</td>
<td>82</td>
<td>74</td>
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<td>Justice</td>
<td>163</td>
<td>168</td>
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<td>173</td>
<td>157</td>
<td>201</td>
<td>210</td>
<td>205</td>
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<tr>
<td>Finance</td>
<td>104</td>
<td>107</td>
<td>121</td>
<td>128</td>
<td>115</td>
<td>113</td>
<td>112</td>
<td>111</td>
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<td>91</td>
<td>90</td>
<td>78</td>
<td>73</td>
<td>79</td>
<td>85</td>
</tr>
<tr>
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<td>16</td>
<td>19</td>
<td>19</td>
<td>17</td>
<td>20</td>
<td>22</td>
<td>21</td>
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<td>Compact II Capital</td>
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<td>1</td>
<td>3</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>11</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,892</strong></td>
<td><strong>1,999</strong></td>
<td><strong>2,402</strong></td>
<td><strong>2,400</strong></td>
<td><strong>2,388</strong></td>
<td><strong>2,415</strong></td>
<td><strong>2,444</strong></td>
<td><strong>2,454</strong></td>
<td><strong>2,563</strong></td>
</tr>
</tbody>
</table>

Notes
1. Based on first 2 quarters of FY2018
and the ministry had adopted a role focused on oversight and regulation. However, this policy was reversed, and during the amended Compact, the MOPW took on a more proactive role in outer-island project implementation and maintenance. The Ministry of Transport and Communications (MOTC) 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 Marshall Islands Shipping Corporation (MISC).

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 3.1 percent over the FY2003–FY2008 period. Since that time, the size of the public sector has grown modestly, adding another 163 jobs, an annual rate of 0.7 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 1.8 percent annual wage drift has occurred between FY2008 and FY2018. In FY2013, salaries for teachers and nurses increased due to improvements in teacher qualifications and higher pay scales to retain nurses moving to better-paid locations elsewhere. Moderate annual increases in wage rates can represent sound policy intended to attract and maintain a qualified workforce. However, this pattern has added to the overall cost of government in an environment with limited fiscal space.

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 2,563. 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 366 jobs, or 2.6 percent per annum, and, in the case of the Compact sectors, by 206 jobs, or 1.6 percent per annum. A major growth area has also been in federal-programs employment, which has grown by 54 jobs, or 2.0 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.

**3. Expenditures rise to match large increase in revenues**: With the advent of the Parties to the Nauru Agreement (PNA) and the Vessel Day Scheme (VDS), surplus revenues have boomed. Government drew down $7.9 million in fishing-fee revenues from MIMRA in FY2013, which rose to $12 million, $15 million 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 MIMRA compared with a level of just $2 million back in FY2010. Yet expenditures had risen to such an extent that the overall balance had only improved by $3.4 million. 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.1 In the upside, governments have a tendency to expand expenditures, and on the downside restrict capital outlays, both of which are contrary to sound fiscal management. The World Bank in an earlier work explains fiscal responsibility:

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

<table>
<thead>
<tr>
<th></th>
<th>FY04</th>
<th>FY06</th>
<th>FY08</th>
<th>FY10</th>
<th>FY12</th>
<th>FY14</th>
<th>FY16</th>
<th>FY18</th>
<th>Change</th>
<th>Annual % change</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Fund</td>
<td>829</td>
<td>870</td>
<td>908</td>
<td>942</td>
<td>932</td>
<td>1,096</td>
<td>1,132</td>
<td>1,194</td>
<td>366</td>
<td>2.6%</td>
</tr>
<tr>
<td>Compact II</td>
<td>897</td>
<td>1,188</td>
<td>1,135</td>
<td>1,130</td>
<td>1,168</td>
<td>1,055</td>
<td>1,058</td>
<td>1,103</td>
<td>206</td>
<td>1.5%</td>
</tr>
<tr>
<td>Special revenue</td>
<td>70</td>
<td>77</td>
<td>87</td>
<td>46</td>
<td>31</td>
<td>32</td>
<td>27</td>
<td>28</td>
<td>-42</td>
<td>~</td>
</tr>
<tr>
<td>Federal grant</td>
<td>167</td>
<td>234</td>
<td>228</td>
<td>230</td>
<td>244</td>
<td>235</td>
<td>230</td>
<td>221</td>
<td>54</td>
<td>2.0%</td>
</tr>
<tr>
<td>ROC</td>
<td>36</td>
<td>30</td>
<td>38</td>
<td>26</td>
<td>26</td>
<td>13</td>
<td>4</td>
<td>0</td>
<td>-36</td>
<td>~</td>
</tr>
<tr>
<td>ADB</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>-</td>
<td>~</td>
</tr>
<tr>
<td>UNDP</td>
<td>1</td>
<td>3</td>
<td>5</td>
<td>9</td>
<td>14</td>
<td>12</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>~</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,999</strong></td>
<td><strong>2,402</strong></td>
<td><strong>2,400</strong></td>
<td><strong>2,381</strong></td>
<td><strong>2,415</strong></td>
<td><strong>2,443</strong></td>
<td><strong>2,454</strong></td>
<td><strong>2,550</strong></td>
<td><strong>550</strong></td>
<td><strong>1.8%</strong></td>
</tr>
</tbody>
</table>

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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”.

Principles of fiscal responsibility: In Pacific Island nations, fiscally responsible acts have included the following four principles:

- Managing debt at prudent levels, and operating expenses within operating revenues over the medium term
- Maintaining levels of net worth to provide a buffer against factors that may adversely impact net worth in the future
- Managing fiscal risks prudently
- Pursuing policies that are consistent with a reasonable level and stability of tax rates for future years

Reporting: Should the government wish to temporarily depart from the principles of fiscal responsibility, the law requires the government to specify the reason for departure, the approach intended to restore the principles and the time over which restoration is anticipated. In addition to defining the principles of fiscal management, fiscal-responsibility frameworks usually entail a series of budget and reporting requirements:

- The budget call
- An annual fiscal strategy, presented at the time of budget delivery
- An economic and fiscal update, including economic and fiscal forecasts and statement of tax policy changes, on which the budget was formulated
- Half-yearly economic and fiscal update

Special requirements of fiscal responsibility in the RMI: In 2012, the then minister of finance submitted Bill No. 20 to the Nitijela, entitled Fiscal Responsibility and Debt Management, although the bill focused on responsibility rather than debt management. Many of the elements listed in the present discussion are included in the former Bill No. 20. However, there are certain additional requirements a responsibility framework would need to address given Palau’s particular circumstances:

- **Cash flow management**: This is defined as maintaining sufficient fiscal balance and reserves to enable smooth operations of the government and payment of expenditures. In economies with a central bank or developed capital markets, the government can borrow to smooth out irregularities in the short term. The RMI does not have access to such funding and needs to hold a sufficient buffer of cash balances to avoid payment arrears.

- **Cyclical downturns**: The nation also needs to be prepared for cyclical developments, usually in the medium term, that arise from adverse world economic conditions, as with the recession in FY2008, or natural disasters and climatic events. These downturns may result from adverse changes in the external terms of trade, such as fuel-price shocks, food-price increases, or price reductions in primary commodities (e.g., coconut oil and fish). Again, suitable reserves are needed to offset cyclical movements in the world economy or natural disasters.

- **Structural surplus**: The rapid increase in revenues from fishing-fee royalties has radically altered the fiscal environment confronting the RMI. From a situation of constrained resource availability and structural deficit, the nation now faces a period of structural surplus through the end of the amended Compact. Given the uncertainties of the amended Compact era, the RMI needs prudential management of the surplus to meet current priorities and set aside resources for the future.

- **Insufficiency of the CTF**: Current estimates of the potential yield from the CTF\(^1\) indicate considerable risk and that there is a 35 percent chance that the RMI can anticipate a zero distribution in 1 out of the 26 years between FY2024 and FY2050. It is clear the RMI would be well advised to set aside further resources to ensure a
sustained flow of resources to support the operation of government and to improve weak periods of market performance.

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 Comprehensive Adjustment Program (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 Public Sector Program (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 lower and upper 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 recommended RIF:** In the RMI, the civil service represents nearly 40 percent of the cost of current operations. The advisory group recommended implementing a reduction in force (RIF) ranging from 50 to 400 civil servants, with a cost savings of $1.7 million to $4.9 million.

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

1 See chapter 7, “The Compact Trust Fund.”
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 300, 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 $4 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 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 Tax and Revenue Reform and Modernization Commission (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 Pacific Financial Technical Assistance Center (PFTAC) for technical
assistance 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 a net profits tax**: introducing a net profits tax 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; and

- **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, barring 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. However, after a set of public-awareness meetings, the VAT was accepted as part of the tax-reform initiative.

**Reforms go on back burner**: Laws have been drafted for a series of tax reforms, including a net profits tax, a Marshall Islands consumption tax, and a 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 current policy is to re-examine the position of key stakeholders, namely those in the private sector, and reinitiate the process. 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 US. Once it is understood that the incidence of the VAT does not fall on the private sector, it may be possible to reignite interest in a key area of reform.

**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 US asked the RMI to prepare a decrement-management plan over the medium term. At the Joint Economic Management and Financial Accountability Committee (JEMFAC) meeting in September 2009, JEMFAC Resolution 2009-1, “Sustainability of Sector Budgets,” was adopted as follows:
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, restricting the use of Compact funds was adopted. During the first half of 2013, the RMI adopted and submitted to the US 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, proposing ratio-based allocation restrictions for a series of cost categories.¹

THE DECREMENT MANAGEMENT PLAN (DMP)

RMI agrees to prepare DMP: 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 a Decrement Management Plan. A leadership meeting was convened in Majuro in July 2014 to craft the Decrement Management Plan (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: 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,

¹ More detail on the JEMFAC decrement issue can be found in the FY2014 Economic Review.
FY2018–FY2020 and FY2021–FY2023. Since the FY2015 budget process was well advanced, it was decided to initiate the reductions in FY2016. Clearly, the long-term horizon and likely changes in economic performance from those 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.

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 remaining 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 selected, the magnitude of the adjustment. The four alternative measures, as well as 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 million 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 MIMRA had grown to $15.7 million at the time of the DMP and attained a value of $34.1 million in FY2017. This explosive growth reflects the impact of the Parties to the Nauru Agreement (PNA) and the introduction of the Vessel Day Scheme (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 present 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.

**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 ($15.5 million in FY2017). 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 $3.6 million in the FY2017 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 Macroeconomic and Fiscal Forecasting Framework (MFFF) to determine whether they were consistent with fiscal stability through the remainder of the amended Compact period. 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 27. 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 decrement-management plan—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 social security system.

**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.

**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 a structural surplus (at least through FY2023). Implementing the DMP has thus gone on the back burner as the RMI has been able to offset

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1 See chapter 9 and appendix 2 for discussion of the MFFF.
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 to the MTBIF to ensure adequate funds are allocated to maintain essential services in education and health.
5. State-Owned-Enterprise Reform

With high levels of subsidies and capital transfers to the SOE sector, at an average of 10 percent of GDP over the last three years, the ailing sector continues to be a major issue of concern.

- Recent legislation in the 2015 State Owned Enterprise Act requires SOEs to operate on a commercial basis, with identification of community-service obligations (CSOs), and requires the establishment of an SOE-monitoring unit in the Ministry of Finance. The law provides a sound framework for SOE management and should if implemented lead to an improvement in SOE performance.

- The SOE-monitoring unit (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. Establishing the SOEMU with qualified staff on a sustainable basis will however require overcoming the severe capacity limitations that exist.

- The Marshalls Energy Company (MEC)—a strategically positioned SOE during the time of the 2008 financial crisis—and high energy prices threatened the fiscal stability of the nation. An ADB program loan may help with debt restructuring and improvements to management. While the MEC is still basically insolvent and fails to make a positive return, it no longer requires subsidies apart from community-service obligations for power production in the outer atolls.

- 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. Failures of the government to fulfill its commitment have led the NTA to default on its loans, although these are now up to date. The World Bank initiated sector reforms, but it failed to gain widespread support for market liberalization.

- Air Marshall Islands, providing air transport to the outer atolls, has also been an SOE perpetually running under crisis requiring significant subsidies and capital injections. Under new management, services have been improving, but tariffs need reform and CSOs need identification to allow the airline to operate commercially.
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 28 a graphical presentation. As a whole, the sector made an average operating loss of $3.4 million over the FY2015–FY2017 period and incurred average subsidies of $12.6 million. Capital transfers to finance fixed-asset levels required to maintain operations were also significant, averaging $9.2 million. Rates of return on assets and on equity were −2 percent and −4 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 percent and -12 percent, respectively. Thus, it might be argued there has been some improvement. However, rates of return remain well in negative territory. Current subsidies during the last three years now represent an average of 15 percent of general fund revenues. Including capital transfers, the number rises to an average of 27 percent. Once merely an important financial issue, the RMI government’s level of subsidy to the SOEs is now approaching five 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

![Figure 28](image-url)

Table 12
SOE financial performance, averages FY2014–FY2017

<table>
<thead>
<tr>
<th>SOE</th>
<th>Operating Income</th>
<th>Current subsidies</th>
<th>Capital transfers</th>
<th>Total assets</th>
<th>Total liabilities</th>
<th>Equity</th>
<th>“on assets”</th>
<th>“on equity”</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMI</td>
<td>-344</td>
<td>1,910</td>
<td>1,283</td>
<td>10,398</td>
<td>6,708</td>
<td>3,689</td>
<td>-3%</td>
<td>-9%</td>
</tr>
<tr>
<td>KAJUR</td>
<td>-1,838</td>
<td>2,850</td>
<td>1,071</td>
<td>4,870</td>
<td>2,971</td>
<td>1,899</td>
<td>-38%</td>
<td>-97%</td>
</tr>
<tr>
<td>MWSC</td>
<td>-402</td>
<td>0</td>
<td>439</td>
<td>2,299</td>
<td>2,406</td>
<td>-108</td>
<td>-17%</td>
<td>373%</td>
</tr>
<tr>
<td>MEC</td>
<td>2,388</td>
<td>1,383</td>
<td>309</td>
<td>22,850</td>
<td>20,347</td>
<td>2,502</td>
<td>10%</td>
<td>~</td>
</tr>
<tr>
<td>MIDB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MIPA</td>
<td>-2,287</td>
<td>0</td>
<td>5,103</td>
<td>72,081</td>
<td>2,817</td>
<td>69,263</td>
<td>-3%</td>
<td>-3%</td>
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<tr>
<td>MISC</td>
<td>-1,436</td>
<td>1,794</td>
<td>0</td>
<td>1,281</td>
<td>575</td>
<td>706</td>
<td>-112%</td>
<td>-203%</td>
</tr>
<tr>
<td>NTA</td>
<td>-126</td>
<td>1,897</td>
<td>0</td>
<td>31,170</td>
<td>26,612</td>
<td>4,557</td>
<td>0%</td>
<td>-3%</td>
</tr>
<tr>
<td>MRI</td>
<td>-47</td>
<td>25</td>
<td>0</td>
<td>1,861</td>
<td>1,392</td>
<td>468</td>
<td>-3%</td>
<td>-10%</td>
</tr>
<tr>
<td>Tobolar</td>
<td>-2,405</td>
<td>2,760</td>
<td>0</td>
<td>2,281</td>
<td>2,186</td>
<td>95</td>
<td>-105%</td>
<td>-2528%</td>
</tr>
<tr>
<td>Total</td>
<td>-5,216</td>
<td>12,618</td>
<td>9,246</td>
<td>149,089</td>
<td>66,015</td>
<td>83,074</td>
<td>-3%</td>
<td>-6%</td>
</tr>
</tbody>
</table>

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\(^1\) ADB, Review of Public Enterprises and Options for Reform, 2010; Finding Balance, 2011.
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.”

**Government signals intention to reform**: To signal its intention to strengthen governance of SOEs, the RMI Cabinet responded in 2010 with a set of good-practice principles. However, according to the ADB Finding Balance report, “While the foregoing is helpful and, if implemented, will provide useful guidance, the principles are too short on detail to be sufficient on their own. The government should adopt a more detailed SOE policy that could then be used to guide the development of an SOE Act.” However, despite the official adoption of the principles, few were implemented. For instance, the majority of SOEs have yet to develop and publicize business plans. Also, alignment of prices and charges with total cost of service delivery remains a critical area for improvement.

**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. 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 community-service obligations (CSOs) and the impact on commercial viability
- **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
- **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.

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
5. State-Owned-Enterprise Reform

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 a sound piece of legislation.

**The SOE-monitoring unit** 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. Four SOEs have been selected initially by the SOEMU to come under the provisions of the act; these include AMI, the MISC, Tobolar and the MEC. Focus will be on developing business plans and development of CSOs. CSOs will define service delivery for SOEs to provide on a contractual basis to government. 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 problematic.

**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, as with other aspects of public policy execution in the RMI.

**B. SOE Performance**

**THE MARSHALLS ENERGY COMPANY (MEC)**

**The Comprehensive Recovery Plan**: The Marshalls Energy Company’s (MEC) 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. The CRP is now outdated, and the MEC intended to update it and the MEC’s strategic plan during 2017, but the update has been deferred till 2018.

**MEC achievements**: A review of progress made on the CRP since 2010 shows a number of achievements. In 2011, the MEC adopted a new tariff template 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 have not been fully passed on to consumers, permitting the MEC to effectively operate on a full cost-recovery basis. A new contract for an energy-policy, fiscal-management and tariff study funded with ADB support is shortly to be awarded. The study will enable the MEC to permanently operate on a commercial and full cost-recovery basis.

The retirement of the MEC’s commercial debt with the Bank of Guam in early 2011 (facilitated by the ADB PSP loan) freed up cash flow to the company. Part of this cash flow has been used to complete the refurbishing of one of its two large Deutz generators, thus improving the MEC’s generational efficiency. The RUS awarded a $2.3 million competitive grant to refurbish the second Deutz generator, which was completed. 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 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 technical assistance. 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 million 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. Much 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.

**The 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 million and $2.0 million in FY2016 and FY2017, respectively. FY2016 was the first time the utility recorded a profit from generation, reflecting the reduction 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. This position is likely to be eroded further in FY2018. 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 and FY2017. 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

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<th>Table 13 Marshalls Energy Company indicators, FY2007–FY2017</th>
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<td><strong>Utility operations indicators</strong></td>
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<td>(a) net of provision for doubtful accounts</td>
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<td>(c) FY2013 figures adjusted for $2.4 million of ”offset” booked as revenue</td>
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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 low levels, 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 FY2017, the quick ratio improved to 28 percent, an improved performance. As shown in the table, current subsidies to the MEC were $1.1 million in FY2017, reflecting community-service obligations of $0.6 million to support operations in Wotje and Jaluit and $0.5 million to fund maintenance in solar units in the outer islands.

Large accounts receivable: The MEC also continues to have problems with collections. Accounts receivable remain very high, reaching $13.7 million in FY2017, of which $6.6 million is considered as uncollectable and some $7.2 is due from related SOEs and government agencies, with the $4.4 million due from the private sector. Net accounts payable represents some 40 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 Majuro Water and Sewer Co. 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 implement the reforms outlined in the CRP, and continued donor support, the MEC could become an example of a well-managed SOE.
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 its obligations 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.

The next stage of the ICT program was $1.2 million of TA to support the reforms. This included assistance to establish a corporation (open-access entity) to own and manage the fiber optic cable and sell access to a newly competitive and deregulated market. The TA was to help guide the development of a new regulatory framework and establishment of an independent regulatory body. Institutional strengthening was to be provided for the Ministry of Transport and Communications and to prepare the NTA for competition.

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 (WB) 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 WB 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. A draft report has now been prepared by the consultants. This more limited proposal is a welcome step to provide more-detailed and more-comprehensive information on the possible structure of a reformed sector, on the transition and on the financial implications that were absent from the original reform process. With a more tangible analysis presented in a comprehensible fashion, policy makers might become more confident to make decisions that could bring about widespread benefits to the people of the Marshall Islands.

AIR MARSHALL ISLANDS (AMI)

AMI has run major operational losses throughout the amended Compact totaling $14.5 million. These shortfalls have necessitated continued government operating subsidies and capital transfers, amounting to $14.1 million and $9.3 million respectively. Performance has improved during the last two years, with the company close to breaking even. In FY2017, AMI received subsidies from government of $2.5 million, of which $1.7 million was to support
operations, $0.3 million for Social Security arrears, and $0.5 million for debt repayment.

A review of AMI in 2010 documented major shortcomings in the company’s performance and presented a set of policy-reform options for government consideration. A Chamber of Commerce public forum on AMI in April 2011 was followed up by a policy-advisory letter from the Chamber Executive Committee, which argued for more-aggressive reforms by the RMI government. The letter called for, among other things, a new management team, an end to interference in the day-to-day operations of the airline and removal of all elected officials from the board.

AMI 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. For a company that in FY2013 had a 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 was based on six objectives:

- Rebuild the financial base: sell the Dash 8 and replace it with a second Dornier 228, capitalize existing government debt and repay MISSA debt
- Reverse loss making: focus on efficiency gains in operation, improve use of aircraft, strengthen marketing efforts, increase fares and stop flying uneconomical routes or requesting subsidies from the government to compensate for losses
- Restore reliability
- Renew operations: focus on human resource development and training, renew accounting and billing systems, and improve institutional strength
- Restrict state subsidies: aid would support only noncommercially-viable routes
- Repair outer-island airstrips

AMI under new management: The business plan, while appearing to conform to the commercial objectives of the new SOE legislation, 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 loss making and (iii) renewing operations. A business plan for 2019-21 is now under preparation.

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 Marshall Islands Development Bank. However, since its return the aircraft has suffered from low utilization because of lack of adequate MEL (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 the FY2017 budget allocated $2 million to runway improvement, with a further $1 million in each of the budgets for FY2018 and FY2019. 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 has been a company in crisis for decades: While the balance sheet has improved under new management, AMI continues operating at a loss, although it nearly turned a profit in the last two years. Running an airline in an environment such as the Marshall Islands with community-service obligations (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

new management has outlined a way forward in its recent business plan, but there remains a long road ahead.

**KWAJALEIN ATOLL JOINT UTILITY RESOURCES (KAJUR)**

*KAJUR operating losses financed from Compact grants:* KAJUR, which provides power, water and sanitation services on Ebeye, ran operating losses of $1.5 million and $2.3 million in FY2016 and FY2017, respectively. Operating subsidies to KAJUR provided from Compact funding in these years totaled $2.6 million, $1.3 million and $1.3 million. 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 AusAid infrastructure project ($19 million), of which $3 million of construction was booked by KAJUR in FY2017. The EWSSP is designed to improve access to safe water and sanitation and promote behavioral change to improve hygiene standards.

**MAJURO WATER AND SEWER COMPANY (MWSC)**

*MWSC receives hidden subsidies:* Like most SOEs, MWSC ran operational losses: $0.7 million and $0.5 million in FY2016 and FY2017, respectively. The last tariff study was 11 years ago, and MWSC operates well below full cost recovery. However, unlike most other SOEs MWSC does not currently receive any direct subsidy from government. However, this hides a large unpaid liability to the MEC of $2.2 million and $2.6 million in FY2016 and FY2017, respectively; in effect, MWSC fails to pay its electricity bills. Periodically, the government undertakes an “offset” where 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:** MWSC conducted a 20-year development plan, which guides operations and investments. A tariff study is planned together with a business plan to guide business over a three-year period. A Majuro water and sanitation project for $6 million of investments 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 (MISC)**

*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 Communication’s Sea Transport Division. However, the MISC operates below full cost recovery and requires continuing subsidy from the government. In FY2016 and FY2017, the MISC ran operating losses of $1.6 million and $1.3 million, requiring subsidies of $1.7 million and $1.9 million (close to 50 percent of operating costs) in the two years, respectively. As in the case of MWSC, although to a lesser extent, 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 two 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, MWSC failed to receive the maintenance subsidy in FY2014, although it recommenced in FY2015 and was maintained through FY2017.

*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. The management of the MISC has committed to the preparation of a strategic plan for 2016-19. Implementation of the SOE-reform 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. However, as in the case of the other SOEs, it is the role of government to establish the environment in which SOEs with significant social-service obligations can thrive.

TOBOLAR

**Large increases in subsidy:** The Tobolar Copra Processing Plant has run operating losses averaging $1.4 million during the amended Compact and received subsidies from the government averaging $1.5 million during the same period. 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, since then the situation has reversed, as prices reverted to lower, more normal levels, and Tobolar has recorded an annual average loss of $2.3 million. In FY2016 and FY2017, subsidies of $3.4 million and $3.2 million were received, a considerable increase over former levels, which averaged $1.4 million in the FY2010–FY2015 period. The FY2017 and FY2018 budgets include similar amounts and reflect an environment of booming revenues.

**Large unbudgeted allocation of subsidies to outer islands:** 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 the year from $3 million to $6 million. It is likely that the increase will remain in force through the end of FY2019, coinciding with the next round of elections. The current hike, an increase of close to $5 million from the base subsidy prevailing for many years before 2016, represents a very sizeable commitment that may well be hard to sustain in the future.

**Community-service obligation to outer islands:** Subsidies have allowed Tobolar to continue its long-held practice of purchasing copra from outer-island farmers at prices above the world market. This arrangement is considered a social community obligation, targeting low-income farmers, but a number of studies have characterized it as highly inefficient and unsustainable. A 2010 evaluation of Tobolar’s physical and operational capabilities documented major deterioration in the physical condition of its main plant facilities and called for major improvements in its maintenance, safety and personnel management. Responding to this assessment, the government made management changes in the company, including a new general manager and several new board members. The company has invested in new plant and now produces a range of niche products, although whether increased marketing effort and sufficient sales can be achieved to alter the basic financial position will be a major challenge.
The Financial Sector

Commercial bank lending in the RMI is more active than in the Micronesian sister states of the FSM and Palau and achieved a loans-to-deposit ratio of 48 percent (FSM 23 percent, Palau 12 percent). 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 Social Security 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. In the meantime, the government is contributing $3 million per annum to shore up the fund.

- 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 recent IMF Article IV consultation recommended that the RMI not proceed.

- Many risks concerning the issue of the SOV have been identified with macroeconomic stability and anonymity of transactions being some of the major concerns. The facilitation that cryptocurrencies afford to money laundering and financing of terrorism (AML and CFT) is a particular issue.
A. Money and Banking

**Monetary policy:** 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 Marshall Islands Development Bank (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 US, comes under US federal supervisory requirements and is insured by the Federal Deposit Insurance Corp. (FDIC). There is one locally owned bank, the Bank of the Marshall Islands. 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, the Bank of the Marshall Islands (BOMI) is threatened by the potential withdrawal of these services provided by the US, which would result in a serious loss of financial stability to the economy. Moves supported through the IMF with capacity building and strengthening of the Banking Commission are underway to avert this outcome. The existing provider of corresponding-banking services in the US indicated its intention to withdraw but continues to support the BOMI on the understanding that the bank continues 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 in a new section below) has provided further uncertainty.

**Interest rates:** Since there is no independent monetary policy, domestic deposit interest rates are closely aligned with those in the US. During the amended Compact, deposit rates have been low, with average effective rates recording 1.3 percent in FY2017. 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 12.9 percent in FY2017. Lending rates for commercial borrowing are significantly lower than unsecured consumer rates. In FY2017, average rates were 5.7 percent. As in many developing countries, financial intermediation is accompanied by a significant spread between lending and deposit rates.
**Major trends in banking:** Major trends in lending and deposits in the RMI banking sector during the amended Compact are shown in figure 30. 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 percent and 13.4 percent, respectively, reflecting the payout of $29 million in rent owed to Kwajalein landowners. After several years of dispute with the US, the landowners came to an agreement and a large back load 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.

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 4.9 percent and 1.3 percent, respectively. Again, as the impact of the Kwajalein landowner payout had worked its way through the system, domestic credit grew by an annual average of 19 percent between FY2013 and FY2017.

**Loans-to-deposit ratio:** 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 54 percent in FY2017, 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 FY2017 were 23 percent and 12 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 lending standards weaken, reflecting the lack of FDIC regulation in the RMI.

**Foreign assets:** 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.

**Consumer credit:** Figure 31 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 6.8 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 18 percent through FY2017. As pointed out in an International Monetary Fund (IMF) Article IV mission report, consumer lending as a percentage of total compensation of employees is very high in the RMI and has grown from a rate of 39 percent in FY2006 to 64 percent in FY2017. Deducting payments for taxes, social security 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: While extension of credit to the consumer market has provided 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 $4.9 million, or 4 percent of monetary GDP. This rose through FY2009 to $15.9 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 $8.3 million in credit, or 66 percent, in just one year. In the following two years, commercial credit continued to expand and in FY2017 represented 22 percent of monetary GDP, which despite the recent improvements indicates a low level of financial intermediation.

B. Social Security Sustainability

A recent actuarial report prepared for the Social Security Administration on the status of the Social Security 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."

Fund Status: Table 14 indicates the status of the valuation of the fund conducted for 2011 and 2014. As of October 1, 2014, total accrued liabilities amounted to $443 million in comparison to a market value of investments of $72 million. The fund thus had an unfunded liability of $370 million and a funded ratio of 16 percent, a very low percentage. Reflecting the collapsing nature of the system, investments have been falling to support benefit payments,

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2014</th>
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<tbody>
<tr>
<td>Active workers earning benefits</td>
<td>120.4</td>
<td></td>
</tr>
<tr>
<td>Retirees, spouses, children, and disabled workers receiving benefits</td>
<td>145.6</td>
<td></td>
</tr>
<tr>
<td>Fully or service-insured inactive workers entitled to a future benefit</td>
<td>21.4</td>
<td></td>
</tr>
<tr>
<td>Total accrued actuarial liability</td>
<td>287.3</td>
<td>442.5</td>
</tr>
<tr>
<td>Market value of assets</td>
<td>-65.0</td>
<td>-72.4</td>
</tr>
<tr>
<td>Unfunded actuarial accrued liability</td>
<td>222.3</td>
<td>370.1</td>
</tr>
<tr>
<td>Funded percent</td>
<td>23%</td>
<td>16%</td>
</tr>
</tbody>
</table>

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

and by the end of FY2017 recorded a level of $69.6 million. Without reforms, the SS system was projected to collapse by FY2023.

**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 propose 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,\(^1\) 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, and only after the formation of a new administration was the issue taken up again, in late 2016. A new bill was drafted and subsequently 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 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 are projected to be insufficient to avoid eventual fund collapse.

**Divergence between contributions and benefits:** Figure 32 indicates the impact on the SS system of the reforms contained in PL 2017-30, based on 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 at a slow rate, reflecting a weakly growing economy (projections based on chapter 9 of this review). The benefit curve, however, continues its upward momentum and diverges from contributions.

**Nitijela subsidies:** In FY2017, the Nitijela contributed $3 million to the SS Fund, and a further contribution of $3 million and $2.3 million were programmed in the FY2018 and FY2019 budgets, respectively. Contributions of $3 million have been assumed to continue through FY2023 to the end of the amended Compact. As a result, the point of eventual fund collapse is 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 will be necessary to revisit the issue and consider whether further reforms are necessary or government will need to continue support after FY2023.

**Updated actuarial study:** It is important to note that the basis of the 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, which relied on US life tables with Marshallenese data. An updated actuarial study...
study drawing on the experience study has been completed, 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

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.

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 to issue 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 (ML and FT). 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.

Another concern has been the risk to the CBR relationship of the Bank of Marshall Islands with First Hawaiian Bank. Clearly, ML and FT risks associated with cryptocurrencies may adversely affect BOMI’s CBR with First Hawaiian or other international banks, or hamper establishing BOMI’s own facilities in the US. 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 being 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.

The government’s current position, which has emerged since the enactment of the legislation, is that the RMI will not proceed with coin issue 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 recent IMF Article IV consultation to the RMI, a special study on the SOV was undertaken. 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.

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 scores 149, 78 percent down the list, indicating that there is much room for improvement.

- The RMI is a significant participant in the Parties to the Nauru Agreement (PNA), a cartel of nine Pacific Island states. Because of the introduction of the Vessel Day Scheme (VDS), there has been a remarkable increase in member-country revenues. The RMI received over $25 million of revenues from this one source in FY2017.

- A particular issue of concern for the PNA region is the operation of the FSM Arrangement (FSMA) set up to encourage domestic fishing production. However, issue of licenses under the FSMA, frequently to companies that provide no more local value added than their establishing of local offices, incurs considerable loss of royalties.

- 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), a wholly owned subsidiary of a US company, International Registries Inc.

- There is a general lack of factual information and transparency on the operations of 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 Developments

A. The World Bank Doing Business Survey

RMI scores poorly on World Bank 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 scores 140th out of a total of 190 countries, about 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 109th, Fiji 101st, Vanuatu 90th, Tonga 89th and Samoa 87th. Overall, the RMI’s scores are weak. Registering property scores 187th—not quite at the bottom of all countries surveyed by the World Bank—while for protecting investors, the RMI also scores close to the bottom, with a ranking of 177th. Resolving insolvency is also poor at 167th. The RMI registers its best rank, 67th, for trade across borders.

B. Regulatory Framework

Secure transactions: Secure-transactions legislation was introduced into the RMI in 2007 and enables individuals and businesses to use moveable property, but not land, as security for a loan, and 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 proved 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 take-up of the facility.

Business registration: 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

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<tbody>
<tr>
<td>Ease of doing business, overall rank</td>
<td>106</td>
<td>101</td>
<td>139</td>
<td>140</td>
<td>143</td>
<td>149</td>
</tr>
<tr>
<td>Starting a business</td>
<td>52</td>
<td>48</td>
<td>70</td>
<td>71</td>
<td>70</td>
<td>72</td>
</tr>
<tr>
<td>Dealing with construction permits</td>
<td>8</td>
<td>4</td>
<td>10</td>
<td>63</td>
<td>79</td>
<td>71</td>
</tr>
<tr>
<td>Getting electricity</td>
<td>76</td>
<td>73</td>
<td>68</td>
<td>125</td>
<td>126</td>
<td>126</td>
</tr>
<tr>
<td>Registering property</td>
<td>183</td>
<td>185</td>
<td>189</td>
<td>189</td>
<td>187</td>
<td>187</td>
</tr>
<tr>
<td>Getting credit</td>
<td>78</td>
<td>83</td>
<td>71</td>
<td>79</td>
<td>82</td>
<td>90</td>
</tr>
<tr>
<td>Protecting investors</td>
<td>155</td>
<td>158</td>
<td>183</td>
<td>178</td>
<td>175</td>
<td>177</td>
</tr>
<tr>
<td>Paying taxes</td>
<td>96</td>
<td>92</td>
<td>128</td>
<td>125</td>
<td>82</td>
<td>83</td>
</tr>
<tr>
<td>Trading across borders</td>
<td>66</td>
<td>65</td>
<td>68</td>
<td>75</td>
<td>64</td>
<td>67</td>
</tr>
<tr>
<td>Enforcing contracts</td>
<td>63</td>
<td>66</td>
<td>58</td>
<td>65</td>
<td>99</td>
<td>99</td>
</tr>
<tr>
<td>Resolving insolvency</td>
<td>135</td>
<td>140</td>
<td>168</td>
<td>167</td>
<td>167</td>
<td>167</td>
</tr>
</tbody>
</table>

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.
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) 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.

**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 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 purpose, the system could be piggy-backed to 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 issue of concern during the previous tax-reform initiative.

**Foreign investment regime:** Foreign direct investment (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.

Under the current regime, even short-term consultants are required to obtain a foreign-investment business license (FIBL), which, in an environment of limited skills, inhibits business activity. Further, there is ambiguity over the application of the law. Once an FIBL 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.
Foreign work permits: 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 (OSL). Jobs falling under this category would not require advertisement and be subjected to the normal 30-days wait period. Unfortunately, the OSL has yet to be developed.

Bankruptcy: 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.

Land tenure: Clearly defined land ownership 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.

The limited success of the LRA 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 Public Sector Reform Program, the shipping services provided by the Ministry of Transport and Communication’s 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 Marshall Islands Shipping Corporation. 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 SOE-monitoring unit 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:** The recent Private Sector Assessment\(^1\) 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 would firstly require political commitment, something that has been conspicuously absent. The SOE-monitoring unit, a clearly defined set of contractually bound CSOs between government and the SOE, and regulatory support with sufficient human capacity are all necessary conditions. Such would require not only political commitment and RMI support but donor assistance in establishing the functions.

**D. Corporate and Shipping Registry**

**Lack of transparency in TCMI operations and benefits:** 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), a wholly owned subsidiary of a US company, International Registries Inc. 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.\(^2\) 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 payments 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 this figure includes salaries of the corporation’s principals and thus “hidden” profits is not possible to assess.

**Need for intendent 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.

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1. Ibid
**E. Fisheries and the Domestic Fleet**

**Boom in fishing royalties:** 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 from $8.5 million in constant prices at the start to $17.6 million in FY2017. Total fish licensing and associated fees collected by the Marshall Island Marine Resources Authority (MIMRA) have also grown, from $1.3 million to $34.1 million in FY2017, much of it in the last four years because of the implementation of the Parties to the Nauru Agreement (PNA). The PNA is a cartel of nine Pacific Island states. The introduction of the Vessel Day Scheme (VDS) has led to a remarkable increase in member-country revenues. The cost of a day’s fishing rose from a PNA minimum rate of $5,000 introduced in 2012 to $6,000 in 2014 and rose further to $8,000 in 2015. Daily fishing rates currently average over $10,000 per vessel-day, and the RMI received over $25.4 million of revenues from this one source in FY2017.

**FSM Arrangement to encourage domestic fisheries development may lead to large loss in revenues:** A particular issue of 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 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. The daily rate comprises two parts: (i) a fixed proportion goes to the PNA member in whose jurisdiction the fish are caught, and (ii) a reduced rate is negotiated by the host member with the domestic fleet. The issue concerns whether the reduced overall fishing fee and loss in revenue is offset by increases in benefits to the PNA economies. In the RMI case, 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, but at significant loss to capture the rent from the reduced domestic-fee rate. A comprehensive analysis is needed to evaluate whether the domestic fleet makes a net contribution to the RMI economy in excess of that generated from third-party foreign fleets, and thus whether the nation would be better advised to license all of its Party Allowable Effort (PAE) at full VDS rates.
8. The Compact Trust Fund

The estimated value of the CTF at the end of FY2017 was $357 million, including a large $62.4 million increase in FY2017 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 6.84 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 2.1 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 ($26.55 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 12.2 percent.

- Making substantial improvements to the terms of the CTF Agreement would require mutual agreement by the original parties, which for the US entails both executive and congressional approval.
8. The Compact Trust Fund

A. Performance of the Compact Trust Fund (FY2004–FY2017 and projected to FY2023)

BACKGROUND

US indicates no guarantee of distribution level after FY2023: The establishment of the trust fund for the people of the RMI was a major feature of the amended Compact. The trust fund as 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 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.” The GAO also noted that “[it] believe[s] that careful analysis of the trust funds each year will help establish realistic expectations.

Basis of Graduate School (GS) 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 US 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

2 Ibid, appendix V, p. 56.
3 Ibid, appendix V, p. 56.
or large additional contributions over the remaining accumulation period, the real value of the CTF corpus has an unacceptably high likelihood (27 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 (35 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 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.

Market assumptions: It is assumed 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 92-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 $27.1 million (maximum) distribution by a 5.0 percent real rate of return yields a simple sufficiency target of $535 million.

Projected CTF in FY2023 exceeds simple sufficiency level: Using the above-detailed assumptions and starting with the end-of-FY2017 RMI CTF value of $354,656,481, the rate of return required to achieve the simple sufficiency estimate for the RMI CTF of $544 million would be just 2.2 percent annually for the six remaining years from FY2018 to FY2023. This assumes planned contributions from the US and the Republic of China, the subsequent contributor, are fulfilled. Such a rate of growth is more likely than not; however, a risk remains of a less favorable outcome. Using probability analysis, the median projected level of the RMI CTF at the end of FY2023 is $715 million, or 131 percent of the simple sufficiency estimate. In the same modeling process, 92 percent of the cases resulted in an FY2023 balance equal to or greater than the simple sufficiency target of $544 million.

Still, it is clear that 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–FY2017. The experienced asset-weighted rate of return from FY2006 through FY2017 was 6.75 percent. The asset-weighted rate of return from initial funding on June 1, 2004, through the end of FY2017 is 6.38

PERFORMANCE MONITORING

GS projects $27 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 FY2019 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 $35.6 million. Of this, $26.5 million is scheduled to continue to flow via sector grants dedicated to Kwajalein-based activities. With full projected inflation (at 2.05 percent) for FY2024, the $26.5 million is adjusted upward to $27.0 million. That portion of the grants that does not continue is used in this review to estimate the simple sufficiency estimate.

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percent, reflecting the delay in getting the CTF established and fully invested at the outset of the amended-Compact period.

**D account is important supplemental fund:** The RMI has funded the D account within the CTF mechanism. As of the end of FY2017, the value of that account was $15.1 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-endorsed long-term fiscal framework (LTFF) commitments to develop expenditure and revenue policies that take into account the risks faced after FY2023 are both prudent and promising.

**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 33, that estimate is for a fund size of $908 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 the investment climate that has prevailed from FY2006 through FY2017. 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 Compact Trust Funds are described in substantial detail in a separate Graduate School paper, “Compact Trust Funds in the Three Freely Associated States: Mechanics and Stochastic Projections.” 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.

**TRUST FUND PRINCIPLES AND MARKET RISK**

**Benchmarks:** In this section, we define some useful benchmarks and performance measures to aid the analysis:
1. **Target distribution**: This is defined per amended Compact Trust Fund agreement (Article 15.7[b]) as the FY2023 grant-assistance level plus full inflation adjustment, described above as the maximum distribution.

2. **Primary target**: 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. Since the primary target is based on a real (inflation-adjusted) rate of return, it also implicitly provides for reinvestment of earnings necessary to maintain the real value of the fund. This measure of the fund is a benchmark that assumes no market risk. In itself, it is not a measure of fund sustainability since it ignores risk, but nevertheless it provides a useful benchmark.

3. **Sustainability adjustor**: The sustainability adjustor is the percentage above the primary target that the CTF must attain to accommodate an “acceptable” degree of market risk. This is elaborated below.

**Performance measures**: Performance of the CTF is assessed against a series of benchmarks related to the three CTF principles described in the referenced paper as those that are inherent to the CTF arrangement. The simulations in the following sections are conducted over the remaining amended Compact period—FY2018–FY2023—and over the following 27 years through FY2050. FY2050 is chosen as a terminal period during which long-run steady-state values are attained.

1. **Protecting the corpus**:
   a. Probability of attaining the primary target in FY2050
   b. Probability that the FY2050 real value of the CTF is above the FY2023 value

2. **Protecting distributions**:
   a. Probability of attaining the target distribution in FY2050
   b. Average distribution through FY2024–FY2050 as a percentage of the target distribution

3. **Protecting against volatility**:
   a. Probability of a zero distribution in the FY2024–FY2050 period
   b. Average variation in real drawdown between FY2049 and FY2050

4. **Performance indicator**: The performance indicator is an average of the above three main categories with each submeasure accorded equal weighting. Clearly, the choice of the chosen performance measures is subjective, but those selected are considered to be good indicators of the core CTF principles.

5. **Sustainability**: The outcome of any set of simulations that attains a 95 percent performance level is considered sustainable.

**TRUST FUND SIMULATIONS**

**GS CTF simulations follow other studies**: The analysis undertaken in this review follows that in two other recent studies of the amended Compact Trust Funds in the FSM and RMI by the GAO, and by the ADB. Both studies deploy Monte Carlo simulation analysis to investigate the likely performance of the two trust funds and capacity to meet their objectives. The analysis followed here does not depart from this approach. The simulations are based on a simple portfolio comprising equities and bonds. Equities comprise the S&P 500 (35 percent), a global equities index (25 percent) and emerging markets (5 percent). Bonds are comprised of US government bonds (15 percent), US corporate bonds (10 percent) and world government bonds (10 percent). All indices are total-return indices including reinvestment of interest and dividends. Data cover the historical period 1925–2017. Since the inflationary environment

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4 Global Financial Data
projected over FY2018–FY2050 is expected to be lower than the historical series, the simulations have been run in real terms with inflationary expectations added. The inflationary factor is the US GDP deflator, and the simulations adopt the projections made by the US Congressional Budget Office. Further details on the technical aspects of the simulation are provided in the referenced paper.

The simulations start in FY2018 based on the value of the CTF at the end of FY2017, including contributions from Taiwan to the A account but excluding contributions to the D account, which are discretionary funds that can be withdrawn by the RMI. The simulations are split into two periods: the accumulation phase between FY2018 and FY2023, and the drawdown phase thereafter.

**Results confirm prior studies:** The results of the following analysis do not deviate from that of the prior studies and reinforce the expectation that the CTF will be underfunded and distribution shortfalls will be frequent. However, this review emphasizes the particularly adverse nature of the existing trust fund mechanism, and investigates alternate rules designed to provide a less volatile pattern of distributions to minimize the adverse impact on fiscal management. It also investigates alternative possibilities for increasing contributions to the fund.

**PROJECTED VALUE OF THE CTF AND DISTRIBUTIONS IN FY2023 AND THEREAFTER**

**RMI CTF projected value in FY2023 to exceed target:** Figure 34 provides a depiction of the simulated CTF at the end of FY2023 before drawdowns commence. It indicates that from a value at the end of FY2017 of $355 million, the fund is likely to attain a value of $715 million by the end of FY2023 (the median simulated value). While the median value is above the level of the primary target of $544 million, the probability of attaining the primary target is 87 percent. Further, it must be borne in mind that the primary target is only a benchmark and is based on a risk-free assumption. **RMI CTF projected value in FY2023 to exceed target:** Figure 34 thus indicates that while the likely level of the CTF in FY2023 will be above the primary-target level, there will still remain considerable risk (13 percent) that the CTF will be below this level and will not be sufficient to provide a secure stream of benefits to support government operations in the RMI thereafter.

Table 16 provides statistics based on the performance criteria defined above for the set of simulations undertaken in this review. Focusing on the results for the COFA simulations (the framework defined in the CTF subsidiary agreement of the amended Compact) and the measures for protecting the corpus, the chances of the CTF being above the primary-target value in FY2050 are 78 percent, below the probability of attaining the primary target in FY2023. The probability of maintaining the real value of the corpus between FY2023 and FY2050 is 73 percent.

**Average distributions at 94 percent of target:** The second section of table 16 indicates the nature of the annual distributions that can be anticipated after FY2023. In terms of the average distribution throughout the period, the level is 94 percent of the target, while the probability of attaining the target in FY2050 is 83 percent.

**High probability of zero distribution:** In terms of volatility, the probability of experiencing a zero distribution in the FY2024–FY2050 period is a large 35 percent while the average annual variation in FY2050 compared with FY2049 is
8.8 percent. These results bring out the volatile nature of the COFA rules. There is a tendency to extremes of either meeting the target, which is reflected in a high average drawdown of 94 percent, or failing entirely, which is reflected in the high probability of experiencing at least one year of zero distribution. Finally, the overall performance rating of the CTF under the COFA distribution mechanism is 80.7 percent. On its own, this benchmark has little value without comparison to the alternative simulations, which are presented in the table and briefly discussed below. These results confirm the previous studies’ claims that the projected CTF distributions under the COFA rules will be highly volatile and are insufficiently likely to support fiscal stability and the operational needs of the RMI government.

THE SUSTAINABILITY ADJUSTMENT FOR ENHANCED RELIABILITY (SAFER) RULE

SAFER designed to improve performance: In this section, we consider changes in the distribution rules in order to smooth the volatility displayed under the COFA rules while maintaining the value of the corpus, and thus to improve the overall performance of the CTF. The Sustainability Adjustment for Enhanced Reliability, or SAFER, rule comprises two parts: (i) a drawdown level sufficient to ensure the long-run sustainability of the corpus with a high degree of confidence, and (ii) measures for adjustment at the tail ends of the distribution.

Distributions reduced to SAFER levels: In the first part, to define a sustainable CTF level, the primary target is used as the benchmark. Simulations’ were run in 10 percent increments of the primary target to establish what adjustment was needed to achieve an overall score of 95 percent of the performance indicator. These simulations indicated that an adjustment of approximately two-thirds (or 67 percent) above the primary target was needed to attain a score of 95 percent. An estimate referred to as the SAFER-adjusted primary target is defined as 60 percent (1/1.67) of the CTF corpus value in FY2023. The initial component of the SAFER rule is thus to adjust the drawdown to the SAFER-adjusted primary target times the real long-run geometric mean of the return on the portfolio. This distribution is then maintained going forward (adjusted for inflation) unless either of the two tail events occurs.

Tail adjustments: On the downside, a moving adjustment kicks in: a 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 SAFER-adjusted primary target. Downward adjustment continues until the reduction in distribution exceeds the CTF shortfall (the ratio of the actual CTF value to the SAFER-adjusted primary target). At this point, an upward adjustment of 2 percent is made. 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 to the SAFER-adjusted primary target more rapidly.

### Table 16  RMI Compact Trust Fund simulated results and performance

<table>
<thead>
<tr>
<th>Performance Measures</th>
<th>COFA Rules</th>
<th>SAFER Rule</th>
<th>SAFER ++</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Compact Trust Fund Corpus results</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability of real CTF in FY50 &gt; the FY23 value</td>
<td>72.8%</td>
<td>82.4%</td>
<td>85.8%</td>
</tr>
<tr>
<td>Probability of real CTF value &gt; the Primary Target in FY50</td>
<td>77.7%</td>
<td>87.5%</td>
<td>91.1%</td>
</tr>
<tr>
<td><strong>Distribution results</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average distribution through FY24-FY50 % target</td>
<td>94.1%</td>
<td>87.5%</td>
<td>97.4%</td>
</tr>
<tr>
<td>Probability of attaining target distribution in FY50</td>
<td>83.2%</td>
<td>71.4%</td>
<td>88.2%</td>
</tr>
<tr>
<td><strong>Volatility results</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Probability of a zero distribution between FY23 to FY50</td>
<td>34.7%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Distribution % prior year counted for reduction years only</td>
<td>8.8%</td>
<td>0.3%</td>
<td>0.2%</td>
</tr>
<tr>
<td><strong>Overall performance rating</strong></td>
<td>80.7%</td>
<td>88.0%</td>
<td>93.7%</td>
</tr>
</tbody>
</table>

Note: Under the +RMI scenario, an extra $5 million is added annually from FY18 to FY23 and the “D” account is integrated from its end-of-FY16 value.

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1 All simulations run included tail adjustments defined below.
8. The Compact Trust Fund

On the upside, once the CTF attains a certain threshold above the primary target, distributions are allowed to increase as long as the CTF remains above that level. A threshold of twice the primary target is set in the simulations and an increase in annual distributions of 5 percent has been adopted. Withdrawals are allowed to rise until they reach the level agreed in the amended Compact: the inflation-adjusted level of the FY2023 distribution.

SAFER improves performance at no cost: The second column of table 16 indicates the result of adopting the SAFER rules. Clearly, the CTF corpus attains a higher value in FY2050, resulting from the one-off reduced rate of drawdown in FY2024. The average distribution under SAFER falls below COFA, as does the probability of attaining the target distribution in FY2050. However, the real gains are in eradication of zero distributions throughout the period. Most importantly, with adoption of the SAFER rules—and without additional resources—there is a marked improvement in the overall performance rating: from 80.7 to 88.0 percent. To the extent the performance comparison metric is accepted, this would be tantamount to a win-win result for both the RMI and the US at no financial cost.

ADDITIONAL RMI CONTRIBUTIONS (+RMI)

Additional contributions needed: From the foregoing analysis, it is clear the prospects for the RMI economy in the post-amended-Compact period without remedial action will be subject to significant risk. While the last section indicates that rules can be found that result in a less volatile outcome than under the COFA rules, both sets are likely to result in significant reductions in revenues to support the daily operations of government. The implications in an economy with a tiny private sector unable to compensate for declining Compact grants would result in fiscal adjustment, reduced economic output, and migration to the United States and its territories. Clearly, the CTF will not perform its objectives unless additional funding is found.

Fiscal surplus tapped to build up CTF: In this section, it is assumed that the RMI is able to supplement the annual US contributions to the CTF through FY2023 out of the emerging government structural fiscal surplus. This is discussed in chapter 4 as part of the fiscal-responsibility and fiscal-reform scenario. Under this scenario, it is assumed the RMI has sufficient fiscal space to contribute $5 million (inflation adjusted) from FY2019 through FY2023. An initial contribution to the CTF of $13 million is assumed in FY2019, being the value of the existing D account (not included in the above base simulations). It is assumed that after FY2023, the continuing fiscal surplus is first allocated to any CTF drawdown shortfall to support government operations, but thereafter the remaining surplus is contributed to the CTF until the size of the fund reaches twice the size of the primary target. This rule is known as +RMI.

Score approaches target: The results are displayed in the third column of table 16. Unsurprisingly, adding additional resources improves the results and all metrics show higher scores than under the other two scenarios. Overall, a score of 94 percent is achieved, close to the target of 95 percent proposed in this review.
9. The Long-Term Economic Outlook

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

- The baseline projection reflects the current policy environment, experience of the first 14 years of the amended Compact and revealed preference of the RMI government from the FY2017 fiscal outturn and FY2018 and FY2019 budgets. The baseline scenario thus assumes government continues its current path utilizing all available resources without adjustment as the resource envelope tightens with declining real Compact resources.

- However, the projections indicate that despite the recent large increases in revenues, the current levels of expenditures are not sustainable, and the fiscal position will shortly turn into deficit. A fiscal-responsibility and fiscal-reform scenario is presented to improve public financial management, place the RMI on a sustainable path and restore fiscal balance over the long term:
  - Tax reform
  - Expenditure adjustment
  - SOE reform and adjustment
  - Reduction in Majuro landowner utility support
  - Sustained SS support
  - Enhanced CTF contributions

- The fiscal-responsibility and fiscal-reform scenario represents an approach to public financial management that has not been evident in the past. For adoption of the reforms proposed 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.
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 Macroeconomic and Fiscal Forecasting Framework (MFFF). The MFFF presented 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 balance of payments and the monetary account are included. Other refinements include an external-debt module, projections for fishing fees and the MIMRA account, and projections for Social Security. The MFFF comes under the class of models known as financial programming developed by the IMF. A write-up of the MFFF is provided in appendix 2. A set of projection tables and the spreadsheet model can be downloaded from http://www.econmap.org.

Baseline scenario based on current policy: 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. Baseline projections of the RMI economy are made, given the current policy environment, experience of the first 14 years of the period and revealed preference of the RMI government from the FY2017 fiscal outturn and FY2018 and FY2019 budgets. The rapidly rising level of fishing fees and drawdowns into 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 outturn in FY2017 and budgets for FY2018 and FY2019 indicate a programmed use of all available resources, with continuing support for Social Security and enhanced allocations to the CTF. The baseline scenario thus assumes government continues its current path utilizing all available resources without adjustment as the resource envelope tightens with declining real Compact resources.

The fiscal-responsibility scenario: However, the projections indicate that despite the recent large increases in revenues, the current levels of expenditures are not sustainable, and the fiscal position will shortly run into deficit without adjustment. The level of sustainable resources after FY2023 from the CTF implies a further substantial adjustment. A fiscal-responsibility and fiscal-reform scenario is presented that includes a return to fiscal balance and adjustments necessary to increase funding to the CTF and support fiscal sustainability in the long term. The results of chapter 8 have been drawn on to define a sustainable drawdown rate under the SAFER rule with further RMI contributions that are assumed under the +RMI scenario. It is assumed that interest in the tax reform initiative is reignited and introduced. The ongoing PFM reforms with ADB support and implementation of the SOE-monitoring unit are assumed to encourage greater efficiency in the operation of the SOE sector with reduction in subsidies.
B. The Baseline

ASSUMPTIONS

**Fisheries:** The major factors affecting the baseline 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 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. It is assumed that from FY2018 through the end of the amended Compact, the backlog of funds of $36 million is drawn down in a gradual and smooth fashion to avoid creating any adverse economic cycles.

**Booming revenues fund infrastructure projects:** The FY2017 and FY2018 budgets allocated significant additional resources to RMI-funded infrastructure projects. In normal budgets before the boom in fishing-fee revenues, domestically funded infrastructure projects averaged $3.0 million. In the FY2017 budget, reflecting booming fishing-fee revenues, $10.6 million in infrastructure projects was approved. The levels remained high in FY2018 although dropping to $8.9 million. In the FY2019 budget, as the backlog in fishing revenues was used up, infrastructure projects were cut to $2.9 million to restore fiscal balance. It has been assumed that this level of locally funded projects will be maintained during the remainder of the amended Compact.

**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, World Bank, Japan and others. With the switch to a grant-only basis, the ADB now has approximately $6 million a year available for grants. 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 nature of these projects and their composition, timing, and capacity constraints involves considerable uncertainty. The World Bank and ADB have large projects in building climate resilience, water and sanitation that involve significant construction activity. It has been assumed that implementation slowly builds over the remainder of the Compact and is maintained in the future.

**Provision of public services is maintained:** Under the Decrement Management Plan (DMP), the government was committed to reduce payroll costs in FY2018 and FY2021. However, in the current base 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 0.7 percent per annum, 0.9 percent in education, and 0.6 percent in health.

ECONOMIC ACTIVITY

**Economic growth projected to improve in remainder of amended Compact:** Figure 35 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 2.1 percent, above the average growth of 1.7 percent in the first half of the amended Compact. The improved performance reflects the boom in donor-funded infrastructure projects.

**Strong growth maintained in FY2018:** After strong growth in FY2017, the economy in FY2018 is projected to maintain the momentum with continuing growth of 3.7 percent. While the level of use of the infrastructure grant is projected to increase slightly above the FY2017 level, the main impetus for growth comes from the ADB and World Bank projects, although it is still assumed there are considerable capacity limitations. In FY2017, fisheries were a strong contributor to growth, but this is not anticipated to be repeated in FY2018. While general fund expenditures were cut back in FY2018 without the drawdown of MIMRA accumulated reserves, the majority of the adjustment was in nonrecurrent items and thus the impact on the economy was mitigated.

**Growth projected to decline during remainder of amended Compact:** From FY2019, the same general forces exert themselves. Compact infrastructure-grant levels have reached full drawdown levels and decline slowly as the backlog of funds is used up (projected for FY2025). The large pipeline of multilateral donor-funded infrastructure projects is expected to continue to expand throughout the projection period. The level of government recurrent operations is projected to increase modestly in line with inflation and the underlying assumptions indicated in the prior section, despite the emerging deficit. Overall, the rate of GDP growth declines through the remainder of the amended Compact.

**Sources of growth:** Figure 36 indicates the contribution of each major industry to the overall growth of 13.1 percent between FY2017 and FY2023. Clearly, construction is the dominant driving force through the end of the amended Compact. Other activities reflect the general level of demand in the economy, but fisheries remain an important player, although they are no longer the driver of growth they were during the initial part of the amended Compact. Public services continue to grow, reflecting the basic assumptions built into the MFFF regarding public administration, educational services and health services.

**Adjustment to the CTF period:** In FY2024, the first year in which the annual grant allocation switches to CTF drawdowns, the economy declines by 0.2 percent. The baseline scenario assumes that as CTF drawdowns are reduced to a sustainable level (a cut of 19 percent of the base sector-grant level, or $5.5 million), contributions to the CTF and Social Security are no longer affordable. However, while government operations 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, as does GDP. In FY2025 and thereafter, the economy settles at its long-term steady-state rate of 1.3 percent.

**FISCAL PROJECTIONS**

**The FY2017 blowout budget:** The fiscal projections have been made on the premise that the fiscal environment has changed radically since the preparation of the DMP and that the recent outcome in FY2017 and budgets of FY2018 and FY2019 provide an indication of future trends and policies. The FY2017 budget included an additional $25 million of general fund expenditures, or 44 percent above FY2016 levels. The additional expenditures were financed from an additional $24 million of MIMRA funds and a small additional $1 million from other revenues. Total appropriations of MIMRA funds in FY2017 were $40 million and required a $13 million drawdown of MIMRA accumulated savings and investments.

**FY2018 budget deficit planned:** In FY2018, the use of MIMRA funds is budgeted to decrease by $14 million to $26 million and expenditures are budgeted to be cut back by $7.5 million. The difference is to be funded by increases in taxes, ship-registry fees and re-appropriation of funds of $3.8 million—that is, running a deficit. The budget figures seem overly optimistic, and the MFFF assumes the government will need to draw on all surplus funds generated by MIMRA: $30.8 million. This assumption is maintained going forward and is consistent with the PL 2016-23: the MIMRA Surplus Funds Amendment Act 2016.

**FY2019 budget is consolidated but remains in deficit:** In FY2019, general fund expenditures are planned to grow more modestly by $3 million, or 4 percent above FY2018 levels. Departmental recurrent expenditures are set to grow by 3.2 percent, while special appropriations are set to grow by an additional $7 million but include $3 million for the CTF. To maintain balance, outlays on public works and infrastructure have been cut by over $5 million. However, revenues appear overestimated by about $6 million, indicating the likelihood of continuing problems with restoring balance after the FY2017 blowout.

**Revenue projections:** Tax revenues are assumed to grow in line with the tax base, adjusted for estimated tax-buoyancy ratios. Nontax revenues include fishing-fee royalties plus shipping-registry fees and have been discussed above. Compact grants, CTF drawdowns and the large infusion of donor funding are projected as already discussed. Figure 37 provides a projection of revenues and expenditures. Revenues fall in FY2018, reflecting the absence of drawdown of MIMRA reserves, but thereafter grow by an average of 2.3 percent per annum to the end of the amended Compact. In FY2024, Compact sector grants switch to CTF distributions and drop by 18 percent, reflecting an anticipated move by JEMFAC to set distributions at sustainable levels. Overall revenues decline by 4.7 percent in FY2024 but thereafter grow by 2.2 percent through FY2030.

**Basis of the expenditure projections:** On the expenditure side, payroll costs increase because of the recent trend increase in the civil service. Use of goods and services is assumed to grow on trend, about 1 percent above inflation. Subsidies are projected to drop in FY2018, reflecting a return to lower levels following the highs of FY2017. Thereafter they 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 Social Security Administration (MISSA), which are to be maintained at $3 million until FY2023. The projections indicate that this level of MISSA transfers is above operational needs and leads to an emerging and growing deficit.
to an increase in fund reserves. In the Compact Trust Fund period, as the resource envelopes tighten, the government terminates further transfers and MISSA reserves start to decline. As indicated in the prior section, further transfers to the CTF are also terminated in FY2024. “Other” expense, including the $3 million transfer to Majuro landowners for easement rights for utility poles, rises in line with trends. Infrastructure-grant levels have already been itemized.

**Expenditures projected to exceed revenues:** Figure 37 provides a projection of total expenditures, which are projected to rise faster than revenues, implying a growing and emerging deficit. Since the RMI is not in a position to fund a deficit, the nation would be forced to adjust, most likely through cutting back on nonrecurrent expenditures. For FY2024, the government is not assumed to adjust current expense in the switch to CTF distributions, although expenditures on fixed assets are assumed to decline in line with the reduction in transfers. By this stage, the use of domestic resources to fund local infrastructure is no longer tenable. As noted, the government ceases further transfers to SS and the CTF, which frees up resources to fund operations. The fiscal balance improves but remains in deficit. Thereafter, without adjustment the fiscal position deteriorates as expenditure growth exceeds revenues.

**Growing shortfall in funding:** In terms of net domestic financing (NDF), Figure 38 indicates the growing shortfall in funding. The fiscal deficit measures revenues less recurrent expense and expenditures on nonfinancial assets (fixed assets). However, the government is also required to finance external-debt payments. Under the grant-only donor-funding basis, it is assumed that the RMI no longer receives loan finance. In FY2017, net domestic financing recorded a surplus of 3.9 percent of GDP. In FY2018, NDF remains positive, indicating a buildup in reserves, but is reduced to 0.5 percent of GDP, reflecting the deteriorating fiscal position. Thereafter, NDF falls through the period with the exception of a slight correction in FY2024 to -4.9 percent by FY2030.

**Projected fiscal outturn untenable:** The projected fiscal trajectory is clearly untenable, and the RMI will be forced to adjust over the near term. The FY2017 budget set the stage for a large unsustainable increase in expenditures, and the RMI has failed to adjust back to prior levels. Capacity-implementation issues in FY2017 provided carry over of funds to help with the FY2018 budget. The same trend might hold for FY2019, but budgets appear to have largely adjusted to the higher ceilings. The failure to realize the projected revenues in the FY2019 budget is likely to result in a deficit, reflecting the projections of this review.

**C. Fiscal Responsibility**

In this section, we examine the implications of a fiscal-responsibility and fiscal-reform scenario. The reforms adopted in the Decrement Management Plan are drawn on, coupled with continuing support for Social Security and additional funds for the CTF:

- Tax reform
- Expenditure adjustment
- SOE reform and adjustment
- Reduction in Majuro landowner utility support
- Sustained SS support
- Enhanced CTF contributions
The tax reform proposal outlined in chapter 3 is implemented in FY2021, and includes the introduction of a VAT and net profits tax 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 12.5 percent has been selected, which is slightly above the estimated revenue-neutral rate of 11.7 percent. While enhancing revenue effort in FY2021, the reforms are positive over time because of the higher efficiency and buoyancy of the tax.

Expenditure measures: The large explosive budget of FY2017 and unsustainable expenditure allocations in the FY2018 and FY2019 budgets require an adjustment in FY2020. Further recruitment of civil servants in the general fund is put on hold through the end of the amended Compact, and a 10 percent adjustment is made to goods and services in FY2020. The large increase in SOE subsidies in recent budgets is reduced to prior levels, and a cut of 20 percent is made in FY2020. It is also assumed that the SOE reforms introduced as part of the PFM initiative bear fruit: SOE commercialization and payment for community-service obligations (CSOs). 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 cut by 20 percent in FY2020.

Maintaining financial stability: Financial stability is enhanced through building up the CTF with additional contributions and support to Social Security. In the case of the CTF, it is assumed that the government increases the current contribution of $3 million in FY2019 to $5 million through the end of the amended Compact. Based on the CTF simulations referred to in chapter 8, the median anticipated value of the CTF in FY2023 without additional contributions is expected to be $715 million. With the additional funding, the corpus is projected to rise to $763 million and to yield a sustainable drawdown of $22.8 million. This is an improvement over the base scenario by $1.4 million, but still short by $4.1 million needed to attain a smooth transition to the target of $26.9 million. In the case of Social Security, the recent reforms are estimated to have improved sustainability but remain inadequate. Until actuarial projections based on the current reforms and recent “experience” study provide improved projections, it has been assumed continuing support of the $3 million transfer will be required.

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 39. The reforms take hold in FY2020, and GDP is 0.4 percent lower than under the baseline. The freeze on general fund recruitment, reduction in use of goods and services, and reductions in real incomes due to the introduction of the tax reforms all have a negative impact on demand and GDP. However, the offsetting reduction in the wages tax results in only a small reduction in household real incomes of 0.2 percent and mitigates the overall impact on GDP. Overall growth in the economy remains positive at 2.0 percent, reflecting the booming donor-funded projects. In the following periods through the end of the amended Compact, the impact of the reforms implies a reduction in GDP of 0.9 percent by FY2023.

Reforms have strong impact on the fiscal outcome: Table 17 provides further details of the impact of the reform scenario on the fiscal outcome and net domestic financing. The tax reform component generates an increase in revenues of 0.3 percent of GDP in FY2021 at

<table>
<thead>
<tr>
<th>Table 17</th>
<th>Baseline projection of deficit, and difference to base of adjustment measures, FY2015-FY2023 (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (diff % base)</td>
<td>FY20</td>
</tr>
<tr>
<td>-0.4%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Expenditures (diff to base)</td>
<td>-$5.0</td>
</tr>
<tr>
<td>Expenditures (diff to base % GDP)</td>
<td>-2.0%</td>
</tr>
<tr>
<td>Revenues (diff to base)</td>
<td>-$0.1</td>
</tr>
<tr>
<td>Revenues (diff to base % GDP)</td>
<td>0.0%</td>
</tr>
<tr>
<td>Net domestic financing (diff to base)</td>
<td>$4.9</td>
</tr>
<tr>
<td>Net domestic financing / GDP</td>
<td>2.0%</td>
</tr>
</tbody>
</table>
introduction, which rises to 1.0 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. On the expenditure side, there are a series of offsetting reforms. Government needs to make additional contributions of $2 million to the CTF to bring the total contribution to $5 million through FY2023. However, this is offset by reductions in payroll, use of goods and services, subsidies to the SOEs, and Majuro landowner utility transfers. Overall, the impact of the expenditure measures is strongly positive, reducing cost by 2.0 percent of GDP in FY2020 and 3.0 percent in FY2030. Figure 40 indicates the overall impact of both the revenue and expenditure measures on NDF. In FY2019, there is a large NDF requirement, but this is before the reforms kick in during FY2020. From this point forward, NDF stabilizes within 1 percent of GDP. Compared with the base, the reforms generate a reduction in NDF needs in FY2030 of 4.3 percent of GDP.

Reforms require a new era and culture of fiscal and economic management: Overall, the fiscal-responsibility and fiscal-reform 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, if the program is to stand a chance of success.

D. Worst-Case Scenario: Loss of Federal Programs, SEG, and Pell grants

The worst-case scenario: In this section, we consider the possible loss of access to federal programs, the Special Education Grant, or the SEG as it is known, and Pell grants after the expiration of elements of the amended Compact after FY2023. The Compact Trust Fund subsidiary agreement explicitly states which components of the amended Compact are to be funded after FY2023 through CTF distributions. However, the amended Compact does not indicate the future access of the RMI to federal programs, the SEG or other grants such as Pell; it is unclear whether these programs lapse or continue. It is generally assumed that federal programs and Pell grants are likely to continue, although this would require congressional authorization. The position of the SEG is less clear. In this section, we explore the impact on the economy of these changes (i) without adjustment, and (ii) if the government adopts the fiscal-responsibility scenario outlined in the last section coupled with further adjustments to adjust to the loss of the programs.
Significant adjustments required: The projected levels of federal programs, the SEG and Pell grants in FY2024 are $10.5 million, $5.6 million and $5.5 million, respectively. Adding these numbers together, resourcing requirements are projected to rise by $21.6 million in FY2024, or 7.9 percent of GDP—a very sizeable burden the economy would be stressed to withstand. Significant adjustments would be required to restore fiscal balance if the RMI was to lose access. Coupled with the earlier reforms outlined in the last section, a series of further adjustments would be needed in FY2024. Those considered include a reduction in the use of goods and services to their FY2015 levels adjusted for inflation—that is, before the FY2017 budget blowout—and a 30 percent reduction in force (RIF) of government employees funded under the general fund. However, these adjustments do not go far enough, and it would be necessary to reduce education and health services by 10 percent, increase VAT to 20 percent and further reduce support to Majuro landowners by 20 percent. This series of adjustments would restore fiscal balance, but there would be a significant hit to the economy.

Large impact on the budget and GDP: The impact on the fiscal outturn and net domestic financing is indicated in figure 41. In FY2023, the last year of the amended Compact, without reform NDF of 3.4 percent of GDP is required. In FY2024, this rises to 11.4 percent, an increase of 8 percent of GDP, an exceptionally large adjustment. With the series of adjustments and reforms outlined, fiscal balance can be restored. Figure 42 indicates the impact on GDP of the loss of these services. Up to FY2023, the figure indicates the impact of implementation of the fiscal-responsibility scenario, and a loss of 0.9 percent of GDP is projected. However, in FY2024, as the economy adjusts to the loss of a large source of revenues, GDP contracts by nearly 6 percent.

Impact of worst-case scenario on jobs and migration: The MTFF does not explicitly model projections of employment or migration, but reflecting average labor/output ratios for the economy, a loss of 600 jobs might be expected. About 450 jobs would be lost directly from the RIF in government, with 300 in general administration and a further 150 in education and health. This implies an indirect loss of a further 150 jobs. If these people were to migrate together with their families and dependents, close to 3,000 people could be expected to be incentivized to migrate.

Need for RMI and US to plan for future access to federal programs and services: The loss of all federal programs, the SEG and Pell grants is generally considered unlikely. However, the exercise conducted in this section is instructive in that it attempts to quantify the magnitude of the adjustment and thus place on the radar screen the importance of having the RMI and US agree to the future of these critical programs.
Table 18 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 3.8 percent since FY2015).

Long-term fiscal adjustment and reforms under the Comprehensive Adjustment Program (CAP) to address the mid-2000s crisis were not implemented once fiscal pressure moderated, despite the continuing need. The ADB public sector program was partially implemented although reforms at the MEC were the bright spot. The Decrement Management Plan 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 was a large increase in FY2017. A medium score of yellow has been recorded.

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 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 since the recent elections has been to reinitiate the reforms, but no progress so far has been achieved (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 social security system have been passed into law and, coupled with an annual $3 million appropriation, will go a long way to 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 technical assistance the RMI has had a full set of the major economic statistics: GDP, employment, wage data, CPI, banking statistics, balance of payments, international investment position, external debt, and government fiscal statistics. Local capacity remains weak, but capacity building is supported by international donors (coded green).

**Public financial management:** 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 and FY2017 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—Public Expenditure and Financial Accountability (PEFA)—as a means of improving Public Financial Management (PFM). An assessment was made, and a PFM roadmap was prepared. The roadmap will form the core of the coming 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 (coded yellow).

The Medium-Term Budget and Investment Framework (MTBIF) was envisaged as the guiding tool of policy and budgetary resource allocation. However, while the MTBIF was initially compiled as required under the Compact, in subsequent years it was not maintained or used as an active tool of management. For FY2018, with PFTAC support, a more standard medium-term budget was prepared. This is to be built on in the following years (coded yellow).

A system of performance budgeting was implemented at the start of the amended Compact with TA supported by the US, 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 inadequately supported by the World Bank and is due for replacement (coded yellow). **State-owned enterprises:** The SOE sector remains a considerable risk to financial management, with subsidies representing 19 percent of domestic government revenues.

### Table 18 Summary of RMI policy reforms

<table>
<thead>
<tr>
<th>Category</th>
<th>Achievement</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fiscal policy</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>Average fiscal surplus of 3.8 percent to GDP achieved since FY2015</td>
<td>1</td>
</tr>
<tr>
<td>Long-term fiscal adjustment</td>
<td>CAP not implemented; DMP now inactive</td>
<td>-</td>
</tr>
<tr>
<td>Public sector payroll</td>
<td>Sharp increase at start of amended Compact; slippage since FY2015</td>
<td>-</td>
</tr>
<tr>
<td>Tax reform</td>
<td>No progress after many years of active consideration</td>
<td>+</td>
</tr>
<tr>
<td>External debt</td>
<td>External debt position fragile but improving 38% of GDP</td>
<td>+</td>
</tr>
<tr>
<td>Social security</td>
<td>55 reforms undertaken, but sustainability still at risk</td>
<td>-</td>
</tr>
<tr>
<td>Macroeconomic monitoring</td>
<td>Full set of statistics available for economic performance assessment</td>
<td></td>
</tr>
<tr>
<td><strong>Public financial management</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial accountability</td>
<td>Accounting functions improving; capacity building initiated</td>
<td></td>
</tr>
<tr>
<td>PEFA</td>
<td>Assessment undertaken in 2014, provides basis for ADB reforms</td>
<td></td>
</tr>
<tr>
<td>National Strategic Plan</td>
<td>Completed May 2014 but provides little performance/monitoring criteria</td>
<td></td>
</tr>
<tr>
<td>Medium-Term Fiscal Framework</td>
<td>New process being initiated with donor support</td>
<td></td>
</tr>
<tr>
<td>Performance management</td>
<td>Performance budgets in some departments; no monitoring</td>
<td></td>
</tr>
<tr>
<td>Information systems</td>
<td>Captures financial information only; legacy system under replacement</td>
<td></td>
</tr>
<tr>
<td><strong>State-owned enterprises</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subsidies</td>
<td>Subsidies 28% of general fund revenues; significant fiscal risk</td>
<td>-</td>
</tr>
<tr>
<td>Divestment</td>
<td>No entities privatized</td>
<td></td>
</tr>
<tr>
<td>Full cost recovery</td>
<td>All SOEs operate below full cost recovery</td>
<td></td>
</tr>
<tr>
<td>SOE policy</td>
<td>Law passed; but board composition modified; SOE unit created</td>
<td></td>
</tr>
<tr>
<td><strong>Regulatory environment</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI</td>
<td>No reforms undertaken, but FDI realized in fisheries sector</td>
<td></td>
</tr>
<tr>
<td>Land reform</td>
<td>ADB TA executed; minor impact</td>
<td></td>
</tr>
<tr>
<td>Doing Business Survey</td>
<td>World Bank survey places RMI 149th out of 190</td>
<td>&quot;149 was 143&quot;</td>
</tr>
</tbody>
</table>
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 community-service obligations (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 (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 Air Marshall Islands also improved, and the overall level of operating loss of the SOE sector has been reduced (coded yellow).

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 support will be provided to the Ministry of Finance to establish an SOE-monitoring unit (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 Asian Development Bank 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 149th 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 is to accelerate. Despite these limitations, the RMI has achieved a degree of economic growth that would not have been expected for a remote and resource-scarce nation. 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.
This appendix describes the projection methodology of the MFFF to enhance understanding of the results. The MFFF comes under the class of models known as financial programs (FP) developed by the International Monetary Fund. The model is based on the four macroeconomic accounts of a nation: the national accounts, statement of government operations, balance of payments and monetary survey. Each of the four accounts is related to all others. The model relies on simple projection techniques that can be utilized in spreadsheets. This appendix describes each of the major components of the MFFF framework. While it would be possible to specify the model algebraically, the approach adopted is to describe the major elements of the system and refer the reader to the spreadsheet model, which contains notes and can be downloaded from http://www.econmap.org. Four main methods of forecasting have been deployed. These include the following:

- Trend, either 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 with the current-price 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 spreadsheet model contains further details.

6. **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.

7. **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), 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, MIMRA and commercial fishing are projected on trend.

8. **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.

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

10. **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.

11. Government services: Government nonmarketed production is considered a policy variable and projected exogenously. In the base scenario, employment is projected on trend and former reforms of the DMP are assumed no longer implemented. Local government and government agencies are projected as moving averages, while the CMI is projected to grow at a modest rate.

12. 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, gross receipts taxes (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 state-owned enterprises (SOE) have been projected as moving averages.

**PRICE AND WAGE PROJECTIONS**

Model 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 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 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 MFFF, 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 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 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, 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. 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 and payments to the Social Security Administration and for health insurance. Social Security and health-insurance payments are projected to grow in line with the growth in compensation of employees. Social Security 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 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 (MUV) and the US CPI. Change 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 a set of 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 up final government and household consumption expenditures plus gross fixed-capital formation provides an estimate of gross domestic expenditure (GDE). Adding the trade account to the GDE estimates provides an estimate for gross domestic product by expenditure GDP(E). Aggregate demand is estimated as the sum of GDE and exports and is used to drive many of the series in the MFFF. Finally, the difference between GDP(P) and GDP(E) is the national-accounts discrepancy and provides an estimate of the overall reliability of the MFFF series.

**GOVERNMENT FINANCE**

The fiscal account 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. (VAT 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. 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 MIMRA of revenues collected from fishing fees. 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 Marshall Islands Marine Resources Authority (MIMRA Surplus Funds Amendment) Act 2016, all funds in excess of operations needs and fishing-industry development are assumed 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. 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. 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 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 allocated to the net acquisition of domestic deposits.

**BALANCE OF PAYMENTS**

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 freight and insurance on merchandise imports, and business services. 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. Social security 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 has been included in the MFFF 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 the Bank of the Marshall Islands’ 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.
December, 2018

ECONOMIC REVIEW
RMI FY 2017

This review has been prepared to assist the government of the Republic of the Marshall 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