

# 3 FEDERATED STATES OF MICRONESIA

## 3.1 Introduction

The Public Sector Reform Program (PSRP) Loan of \$18 million to the Federated States of Micronesia (FSM) was approved in April 1997, and was to be released in two tranches of \$10 and \$8 million. The loan involved adjunct technical assistance of \$0.92 million to support implementation. A TA of \$540,000 was provided to supplement TA No.2294-FSM, Policy Advisory Team for Economic Management (the so-called EMPAT team). This added a third resident adviser to the team, and was aimed at supporting PSRP implementation at the State level and increasing government capacity to monitor the impact of PSRP. A second TA (No.2786-FSM) of \$380,000 provided assistance in the development of an investment promotion plan and a review of the financial sector aimed at fostering private sector development.<sup>8</sup> The PSRP loan compared with US grant assistance under the Compact of Free Association of \$78 million in the fiscal year ending 30 September 1997.

## 3.2 The Macroeconomic and Governance Context

FSM's ongoing efforts at economic reform should be seen as the latest in a long line of adjustments that the indigenous population has had to make from first European contact in the early sixteenth century, through several colonial administrations, to political independence under the Compact of Free Association with the

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<sup>8</sup> Other recent TA included TA No.2538-FSM, Improved Budget Management (approved 5 March 1996 for \$480,000); TA No.2758-FSM, Improved Economic Use of Land (approved 4 Feb. 1997 for \$550,000); TA No.2832-FSM, Fisheries Management and Development (approved 23 July 1997 for \$934,000); and TA No.2983-FSM, Performance-based Public Resource Management (approved 26 Jan. 1998 for \$988,000). EMPAT II also began in October 1998.

United States. The contemporary governance and economic environments are largely the creation of an interaction between the post-1945 US influence and indigenous societies.

A system of government on the lines of the US model was adopted when Chuuk, Kosrae, Pohnpei and Yap federated in 1979. The states have substantial autonomy, with individual constitutions determining the balance of power between the executive, legislative, and judicial branches of government, and between the national, state, and municipal levels of government. The government structure adds a complicating dimension to efforts at improving governance.

Beginning in 1962, the US funded a substantial physical and social infrastructure development program and an expansion of public administration. This continued under the Compact of Free Association, which provided for annual base, or “block”, grants of \$60 million in FY1987-FY1991, \$51 million in FY1992-FY1996, and \$40 million in FY1997-FY2001, at least 40 percent of which had to be spent on capital projects. Additional grant assistance is given to education, health, energy, and communications services provision; and services and programs such as the US Postal Service, weather services, Federal Aviation Administration and Federal Deposit Insurance Corporation are provided free. Duty free access to US markets is generally available for goods with a domestic value added exceeding 30 percent of output. Finally, FSM people have unrestricted access to live and work in the US. In November 1999, formal negotiations are due to begin over provisions of the Compact expiring in 2001. By the latter date, over \$1,240 million in grants will have been disbursed, a figure approximately equivalent to \$830 per person per year.

The growth performance and structure of the FSM economy largely reflect the impact of the large, changing financial transfers under the Compact.<sup>9</sup> The simple average of the annual real GDP growth rate in 1986-98 is estimated at 1.6 percent, but there is considerable year-to-year variation as Compact funds have been first made available and then stepped down on the five-year cycle. Given annual resident population growth at around 1.5 percent, living standards have stagnated. The extent to which these standards are underpinned by aid flows is indicated by the 1993 estimate that the

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<sup>9</sup> ADB, 1997a, provides a detailed analysis of the FSM economy up to that time.

immediate cessation of Compact assistance in 2002 would produce an overnight drop in per capita GDP from about \$1,445 to \$300.<sup>10</sup>

The booming sector effect of aid is evident in the economic dominance of the public sector, which in 1996 accounted for 62 percent of non-subsistence GDP. The 1994 Census showed that the primary sector accounted for only 9 percent of formal sector employment, whereas the public sector accounted for 49 percent. Those employed in the national public administration and in public enterprises received wages averaging close to \$10,000 per annum - over three times the private sector level. Those employed in state public administration received wages 70 percent higher. The unemployment rate averaged 16 percent, ranging from a high of almost 20 percent in Chuuk to a low of 10 percent in Yap. Almost half of the unemployed were under 25. In this context, emigration, especially of relatively unskilled labor, has been, and remains, a crucial safety valve. In 1994, 5,742 FSM people resided abroad (mostly in Guam and the US), compared with a resident population of 105,500.

The extent to which aid has permitted consumption to exceed the level that domestic production possibilities and international trading opportunities alone would permit is evident in the national and the external accounts. In 1996, total final consumption expenditure was 143 percent of GDP, with government consumption 91 percent and private consumption 52 percent. In 1991-95, the trade deficit averaged around 70 percent of GDP. The current account deficit exclusive of official transfers averaged 80 percent; but inclusive of transfers, the current account was in surplus equivalent to 6 percent of GDP. Following two years of recession in 1996-98, the current account deficit exclusive of transfers fell to 17 percent of GDP in FY1998, and the balance inclusive of transfers rose to 31 percent of GDP. As the Bank's 1996 Economic Report observes, official flows "have underwritten a major structural balance of payments deficit" (ADB 1997a, p.12).

The dependence of government on external financial assistance is shown in Figure 3.1, which presents consolidated data (that is, national plus state). In FY1997, after the second stepdown in Compact grants and some success in increasing domestic revenue, total external grants still accounted for 61

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<sup>10</sup> Reported by the Office of Insular Affairs, US Government, <http://www.doi.gov/oia/chapter7.html>.

percent of total revenue and grants (compared to 64 percent in 1995 and 83 percent in 1988).

The overall balance of the consolidated government finances moved from surplus into deficit in fiscal years 1991-93, back into surplus in fiscal years 1994-95, and again into deficit in 1996-97. However, as the documentation for the last Consultative Group of Donors' Meeting reveals,<sup>11</sup> the consolidated outcomes conceal considerable variation in the fiscal performance of the five governments during the 1990s. The state of Chuuk did not adjust to the first Compact stepdown, instead increasing expenditure on wages and salaries and goods and services. Years of recurrent budget deficits were financed by an accumulation of a stock of arrears that by FY1995 was equivalent to 46 percent of recurrent expenditure. The consequent financial crisis forced a belated fiscal adjustment that generated recurrent surpluses in FY1996 and FY1997. Pohnpei State similarly increased personnel and travel expenditure and ran recurrent budget deficits, though some reduction in other recurrent expenditure categories occurred. Arrears accumulation left the state in financial crisis in FY1998 and compelled the adoption of stronger adjustment measures. In contrast, both Kosrae and Yap states exhibited fiscal discipline, running recurrent budget surpluses in the aggregate during the period FY1991-FY1997. All state governments were alike, however, in their willingness to borrow overseas and to invest the funds in public enterprises that are yet to be profitable.<sup>12</sup>

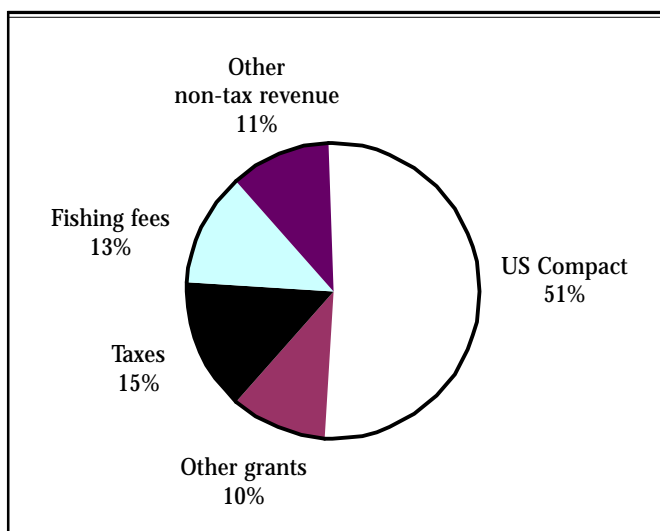
Throughout the 1990s the finances of the national government remained sound. It retained 50 percent of shared revenue and 100 percent of substantial fishing license fees, and played a relatively limited role as a service provider. Given this and the pressures on state government finances, it is not surprising that revenue-sharing has emerged as a major issue in national-state government relations. The split of shared revenue was recently changed to 30 percent to the national government and 70 percent to the state governments; but the additional 20 percent to the states is earmarked for education and health projects, and the states are seek-

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<sup>11</sup> FSM Report to the Consultative Group of Donors, *Adjusting Toward a Private Sector-Led Economy*, 26 January 1998.

<sup>12</sup> In excess of \$15 million was the estimated loss in 1996 (EMPAT Report on Public Enterprise Reform, 1997).

**Figure 3.1: Structure of Revenue and Grants, FY 1997 (%)**



Source: FSM Report to the Consultative Group of Donors, Adjusting Toward a Private Sector-Led Economy, 26 January 1998.

ing a 20-80 split plus a share of the fishing license revenue. Their case is strengthened by the existence of \$15 million in unappropriated revenue in the national government budget for FY1999.

The economic outlook in the medium term is clouded by the prospect of further reductions in Compact grants from 2002.<sup>13</sup> Further fiscal adjustments forced by reductions would impact negatively and quickly on living standards. The private sector development that must be relied upon to generate income and jobs will take time, and cannot realistically be expected to provide the material living standards that large aid flows have made possible.

<sup>13</sup> If re-negotiations of block grant funding are unsuccessful, the Compact provides for an additional two years of funding at the average level of the 15 year period 1986-2001.

### 3.3 The Process of Program Design

#### ***3.3.1 Ownership and appropriate participation in the design process***

For the PSRP, the FSM national government was to be advised by an economic management and policy advisory team (known as EMPAT), which was financed by the Bank through TA 2294-FSM. The first EMPAT team of two resident macroeconomists arrived in FSM in May 1995, and identified the management of reductions in Compact funding as the major economic policy issue. Responding to the team's advice, the political leadership initiated the First FSM Economic Summit, which was held in Kolonia, Pohnpei, in November 1995. It was open to the public, broadcast on radio and television, and included national and state government representatives, politicians, traditional leaders, and representatives from non-government organizations, the private sector, and educational institutions.<sup>14</sup> Each of the 244 official participants joined one of six working committees on agriculture, commerce and industry, health, education, marine resources and tourism. Private papers were presented and speeches made by politicians and representatives of traditional leaders and the private sector; and plenary sessions were held with a view to generating a consensus for change. The overall goal, objectives, strategies and processes of economic reform were outlined for the first time, and a commitment to reform was expressed in a Summit communique. A video tape was prepared and widely distributed.

The reform program was presented to a Consultative Group meeting in Manila in December 1995 (see section 3.3.2); and the national summit was followed by four similarly organized state summits, three within three months, and one in August 1996.<sup>15</sup> Utiliz-

<sup>14</sup> Government of the Federated States of Micronesia, Proceedings of the First Federated States of Micronesia Economic Summit, November 20-24, 1995.

<sup>15</sup> Kosrae State Summit, Commitment to the Challenges, Tofol, Kosrae, 22-24 January, 1996; Yap State Summit, Mobilizing for Sustainable Economic Progress and Social Cohesiveness, 29 January - 2 February, 1996; State Government of Pohnpei, Proceedings of the First Pohnpei State Economic Summit, May 6-9, 1996; State Government of Chuuk, First Chuuk State Economic Summit, Proceedings, 12-15 August, 1996, Weno, Chuuk. The Chuuk summit was delayed due to impeachment proceedings against the Governor.

ing the technical advice of the EMPAT team, each summit confirmed a commitment to the reform strategy agreed upon at the national summit and, within this framework, reached a consensus on state-specific policy reforms and development strategies, and on the need for the prompt formulation and implementation of action plans. The proceedings and findings of all summits received extensive media coverage. Mini-summits were also held at the municipal government level. As a result, community awareness of the nature of FSM's economic problems and the need for reform grew, and soon became an independent source of pressure on governments to act.

However, it should be noted that at the point at which the National Summit product was presented to the Consultative Group meeting, the participative process failed to be synchronized with the political process. While state governors signed a commitment to the program proposed in the Summit, two state legislatures interviewed did not debate the program and consequently did not vote to accept or reject it. For them, the reform program was in large part a top-down imposition, "an alien arrangement" made without much state input and presented as a *fait accompli* - abide by the conditions of the loan or be excluded. Consequently, commitment on the part of state legislatures is far from complete and the prospects of the reform program being vigorously pursued to an effective conclusion are not as good as they might be. In fact, in both Pohnpei and Kosrae, the legislatures indicated that they were about to enter a process of review of some of the impositions of the loan agreement, particularly with regard to conditions of employment. In a nation like Micronesia, where state politicians take their jobs very seriously and debates are broadcast, producing a situation in which state politicians considered that they had been bypassed was unfortunate. Clearly, though, it was not for the Bank to promote the loan to state legislatures. The "champions" should have been the President and the State Governors.

During 1996, each government established task forces that reportedly reviewed the structure and functioning of the public services, prepared public sector investment programs, and developed the Public Sector Reform Program (PSRP) matrices that were to become the design summary and monitoring device for the 1997 program loan. The Bank-supported EMPAT team played a crucial advisory role in these processes.

There have been no further summits since the first round in late 1995-early 1996; but there have been several symposia on reform topics (such as leadership, banking, fisheries and investment promotion), and there are plans for state and national summits to be held following the March 1999 national elections and prior to Compact negotiations.

### ***3.3.2 Partnership and consultation with other external funding agencies***

The reform strategies developed at the November 1995 National Economic Summit were presented to a Consultative Group (CG) meeting in Manila on 6 December.<sup>16</sup> At this meeting, the delegations from Australia, Japan, the United States, the ADB, the IMF and the World Bank expressed their support both for the wide-ranging participative process through which the PRP had been formulated and for its general content. Subsequent CG meetings have been held in Manila on 28 October 1996, and in Tokyo on 26 January 1998, with international representation extending to include the People's Republic of China, France, New Zealand, the Forum Secretariat, PFTAC, UNDP and UNICEF.

### ***3.3.3 Effectiveness of internal processing procedures***

Bearing in mind that formulation of program assistance to FSM necessitated visiting four widely dispersed island groups and negotiating with five governments, processing procedures were efficient. Fact finding was completed between 18 August and 5 September 1996, with a follow-up mission during 18-22 October. Appraisal was conducted between 23 November and 5 December 1996. Loan negotiations were undertaken over 10 days in late March-early April 1997; and Board approval for the loan was granted on 29 April. Loan agreement was finalized on 23 May and became effective on 27 June.

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<sup>16</sup> FSM, *The Road to Reforms and Responding to the Challenges*, papers prepared for the CGM.

### 3.4 The Content of the Program

#### ***3.4.1 The Public Sector Reform Program***

The PSRP was developed as a subset of the broader economic reform program. The overall goal was the “Transformation and development of a more efficient FSM economy as the end of Compact funding approaches”. The five key outputs of the PSRP were to reduce the size and operating costs of the civil service; to increase domestic revenue generation; to restructure government operations; to restructure public enterprises; to mitigate social and economic impact; and to foster development of the private sector. The various activities expected to generate these outputs, together with quantitative targets, were described in five individual matrices and a consolidated PSRP matrix. The five matrices so consolidated contain 122 separate policy actions. Key actions are discussed below. Allied to the program loan was a planned expansion of the EMPAT team to assist with reform implementation and to improve governments’ capacities to monitor the social and economic impacts of the reform program.

All of the conditions for release of the first tranche were satisfied before loan approval in April 1997. Release of the second tranche originally was scheduled for March 1998 and required the satisfaction of a subjective general condition and three specific conditions (Appendix 1). The general condition was that “sufficient progress has been achieved and maintained in carrying out the respective reform programs as set out in the second tranche column of the policy matrices” (para 69 of the RRP). The three specific conditions that had to be met by the national government and at least two of the states before any release of funds were: (1) reduction in the number of public service employees as specified in the matrices; (2) passage of foreign investment laws at national and state levels; and (3) enactment of amendments to the Gross Revenues Tax, and of a new Customs Act.

The time frame for loan release put pressure on (1) the identification and agreement of key factors in the relationship between national and state levels of government; (2) the identification of core areas of government which had to be resourced and how the services in these core areas would be most effectively and efficiently delivered; (3) the whole question of participation and the production

of a careful information program so that the electorate was cognizant of what was happening; and (4) an orderly process whereby the public sector moved to its reformed state.

Three risks were identified as potentially preventing successful implementation and effectiveness of the reform program: (1) a lack of domestic expertise and institutional capacity; (2) a loss of political will; and (3) a failure of the private sector to replace the public sector as the engine of growth. The first risk was to be minimized through the use of EMPAT and counterpart training (though EMPAT originally did not have a public administration expert as a member). The second risk was to be reduced through making retrenchment of public servants voluntary and transparent. The third risk was a given: only time would tell how responsive the small private sector would be to public enterprise reform and an improved economic policy environment.

Key reform actions included:

- **Establishment of task forces on government restructuring to determine fixed targets for realistic and sustainable staffing needs.**

The organizational arrangements for, and the composition of, these important task forces are not provided in the policy matrix. Task force reports would be expected to analyze current public service staffing patterns and functions, and to identify government activities that could be eliminated, privatized or transferred to other service providers. They would present a broad picture of the public sector and its reformed role, given various funding scenarios; an assessment of the jobs that should be done by local public servants and those that might require expertise from outside Micronesia; and flexible targets for realistic and sustainable staffing needs. The reports would then be expected to form the basis of each government's public sector reform program.

If task force reports were produced, they were not available to the Task Force mission.

□ **Reductions in personnel and conditions of employment of public servants accompanied by freezes on recruitment, promotions and reclassifications.**

The purpose was to reduce the wage bill by a given amount, to produce balanced budgets. The specifications were very detailed, eliciting a number of problems, which include:

- A lack of clarity about the reformed core functions of government and the organizational arrangements required to fulfil them.
- An absence of a consideration of alternative ways of effectively delivering particular services (e.g. in the education sector through the merging of schools and reduction in teacher numbers, rather than a uniform reduction in contact hours).
- An absence of an effective mechanism to ensure that the downsizing was applied consistently across government and that the new establishment levels were held.
- An absence of any incentives to the continuing workforce to increase its productivity and make up for the reduction in resources. The reduction in conditions of employment was unremittingly negative - retrenchment, freezes on promotion and job reclassification, time off in lieu of overtime payments, restrictions on leave accruals, a freeze on automatic step increases, reduced wages or days worked, or both. On the output side, some workers were being asked to do their original jobs as well as the jobs of those retrenched. There was an alternative - the same reduced cost of payroll in the budget with more staff retrenched. Better rewards could then have been provided for those remaining. Those rewards could have been linked to productivity gains. Only staff unable to produce improved levels of productivity would suffer the proposed negative consequences.

- **Mitigation of the impact of retrenchments through early retirement schemes and provision of counselling and training services.**

Retirees were all to be given an option of a lump-sum payment of two years' salary, together with counselling and training. Unfortunately, insufficient attention was paid to the latter, and a key governance challenge of the reform program went unmet, namely to ensure that there was real understanding of the consequences of individual actions related to the program before any concerted action was taken to implement it.<sup>17</sup> Additionally, the suggestion that retrenched public servants could find alternative employment in the domestic private sector was unduly optimistic, given so much private sector activity was dependent on a public sector that was to be downsized. Many people who took the package - and they could only obtain the lump sum payment if they presented a business proposal - were without prior business experience and faced a difficult environment in which to start new entrepreneurial ventures.

#### **3.4.2 Rationale and appropriateness of loan amount**

As observed in the RRP (para 53), the loan was in large part aimed at financing the one-off, up-front costs of early retirement schemes. The original request from the national government in March 1996 was for \$15 million to cover the direct costs of these schemes plus the costs of related counselling and retraining in each of the states. In October 1996, it was established that the national government was seeking an additional \$3 million to fund the up-front costs of its own retirement scheme, bringing the total re-

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<sup>17</sup> In Micronesia, much of the less skilled part of the workforce would have had no prior experience of sudden access to large sums of money. For them, an offer of an apparently substantial sum of money to leave employment might well appear irresistible. The extended family dependent on that person's income, armed with a realistic explanation of life after the capital sum had been exhausted, might make a different decision. For the designers of a reform program, the downside of too much realism is the possibility of insufficient applicants for a voluntary package. If that were to occur, however, a more Micronesian solution to a very difficult problem might be formulated.

requested loan amount to \$18 million. Distribution would be as follows: \$5.3m to Chuuk, \$4.2m to Pohnpei, \$3.5m to Yap, \$2.0m to Kosrae, and \$3.0m to the national government. Bank staff involved in processing the loan emphasized that it was to be seen in the context of the overall economic reform program, and not simply as a means of financing a public service downsizing.

In the RRP (para 62), it is observed that:

*The size of the loan is based on the scope and the costs of the policy reforms, the importance and urgency of the reforms, and the state of public finances.*

Details of the costing of reforms and of the fiscal targets aimed at are not available from Bank files or any other source. Presumably, some calculations were made by the EMPAT team of the extent to which the wage bill had to be reduced in order to adjust to the 1 October, 1996 reduction in Compact funding. The funding reduction was \$15 million, equivalent to approximately 25 percent of consolidated personnel expenditure in FY1996. Under the PSRP, workforces were to be reduced from FY1996 levels by 25 percent in the case of the national public service, 29 percent in Chuuk, 13 percent in Kosrae, 25 percent in Pohnpei, and 28 percent in Yap. No without-loan reform scenario seems to have been presented.

### **3.4.3 Consistency with country and Pacific strategy**

Both the rationale for the program loan and the content of the PSRP are consistent with the Bank's Pacific strategy, and the specific country strategy:

*Policy reform and improved economic management are the overall strategic objectives of Bank operations in FSM...During the 1996-99 period, a first priority is stabilizing public finances (FSM Country Strategy, p.54).*

### **3.4.4 Relevance and focus**

The PSRP's general relevance is clear in that public service downsizing, public enterprise reform, and facilitating private sector-led development are accepted objectives identified at the

November 1995 National Summit. The focus is on public service downsizing in the short term, as a means of addressing the need for reductions in expenditure on personnel. There is relatively little attention given to public enterprise reform and private sector development beyond requiring a number of reviews. Nor is there any attention given to the fundamental issue of revenue-sharing between the national and state governments - an issue on which the program loan could have potentially provided some leverage.

### ***3.4.5 Appropriateness and sustainability***

The PSRP design provided for a public service downsizing, but left to be determined the more difficult task of identifying what services governments should provide in the future, deciding how government operations could be restructured to deliver these services, and formulating an action plan with a timetable. The services of an expert in public administration should have been acquired at the design stage, in order to assist in the undertaking of this task. (An expert eventually was recruited, and arrived in FSM in January 1999).

In the absence of an agreed basic framework of government post-reform, there is a risk that a public sector reform program will strip too far in some areas and not far enough in others. This stricture applies both to levels in a hierarchy (removing too many managers, key personnel and key classes of personnel) and to the capacity of an organization to continue to deliver core services at an appropriate service delivery level. In FSM there was a strong case for planning the government sector from a base of what the country could afford from its own revenue streams. Such a level would require only the most productive of the workforce and the most accomplished managers. Consequently, it would be important in any public service downsizing program that this core of the workforce was not eroded at all.

### ***3.4.6 Likely impact on governance***

There is little attention to the quality of governance in the PSRP. This is surprising, since poor fiscal policy formulation and implementation, particularly weak public expenditure management, was the core problem that the reform program addressed, and the Bank's governance policy was adopted in October 1995.

### **3.5 Implementation**

#### ***3.5.1 Actions to date***

As noted above, actions required before first tranche release were completed before loan approval, but release of funds was delayed until August 1997. Subsequently, all five governments drew down their shares of the \$10 million to finance their early retirement programs.

Conditions for second tranche release were not fully met on schedule (March 1998) as a result of delays in downsizing of the national public service and in the passage of foreign investment acts. In July 1998, a review mission recommended a partial drawdown of \$4 million be allowed for the national government and Yap and Kosrae, but not for Chuuk and Pohnpei because the required foreign investment legislation had not been passed. Additionally, in Pohnpei's case, legislation to raise additional taxation revenue and to enable privatization had not been passed, and OPO judged that the state was renegeing on the spirit of the PSRP by engaging directly in commercial activities. The review mission recommended that the program loan's closure date be extended to May 1999 to allow Pohnpei time in which to comply with tranche conditions. The remaining second tranche conditions had been met by March 1999.

#### ***3.5.2 Use of loan and counterpart funds***

Counterpart funds equivalent to \$14 million have been utilized for the funding of the one-off costs of the early retirement schemes, which began in late 1997 and were almost complete by early 1999.

#### ***3.5.3 Process and organizational arrangements***

Two key elements in any process of public sector reform are the existence of a champion and a mechanism to ensure that there is a "driver" which ensures that the timetable and objectives are adhered to. Access to public relations skills are extremely valuable so as to ensure that voters understand that the harsh actions have to be taken for a demonstrable future good (though providing such access is rarely part of even highly participatory reform programs).

In early 1999, no clear champion or driver of PSRP was evident, and there seemed to be little attention being paid to managing a continuing media campaign promoting the program.<sup>18</sup>

No clearly articulated and comprehensive plan of public sector reform was evident in early 1999 either. EMPAT advises both levels of government on fiscal and public sector reform, but has been operating without a plan of where the reform program is going and how it is going to get there. The Consolidated PSRP policy matrix is only a set of conditions that must be realized to ensure the release of loan moneys; and the EMPAT work plans consist of items like “advisory and technical support for improved personnel management” that would not normally be part of an action plan. This reflects the composition of the EMPAT team which, until the arrival of the public administration expert in January 1999, was made up entirely of economists.

Given the constitutional circumstances of FSM, the organizational arrangements for EMPAT are not ideal. It is located at the national level in the national capital and, as far as the State governments interviewed were concerned, advises the national Government. Visits by members of the EMPAT team to assist the States have been infrequent.<sup>19</sup> The terms of reference for EMPAT endorse the view that the national Government directs EMPAT, with the work program formally being determined by the President and actually by a Steering Committee consisting of the national Secretaries of Economic Affairs, Finance and Administration and Foreign Affairs. Though individual members of EMPAT have been allocated specific

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<sup>18</sup> The most often used “driver” of a reform program is the head of finance and the mechanism used is some kind of expenditure review committee operating through the budget and chaired by the head of finance. Co-opted onto the committee are heads of other key “spending” departments in the government. In a federal situation such as FSM, there seem to be two alternatives to make such a mechanism work. A collaborative effort could be mounted in which the President or his delegate and each governor form the committee and review all budget expenditures. Alternatively, the program might be driven from the national level with the national budget providing incentives in the form of additional grants to encourage the states to adhere to the agreed program. In the FSM situation, the national legislature and not the President has power to distribute current account budget surpluses in any way it considers fit. Consequently, a mechanism would need to bind the national legislature into the process.

<sup>19</sup> The Reform committee in Pohnpei, the island on which the national capital is situated, told the Task Force mission that it had received only one visit in the past nine months from its EMPAT representative.

state governments to assist, in a federal system the objectives and means of national and secondary levels of government are not necessarily in harmony, especially in the significant area of fiscal transfers. Consequently, the EMPAT team, from time to time, must experience a conflict of interest in advising the national and state levels of government.

Organizational arrangements for EMPAT have also been complicated by the way in which additional technical assistance for improved budget management has been introduced. Given that this assistance focuses directly on the reform program, it would appropriately be located within the EMPAT team and thus be integrated with the team's program. Instead, 13 months of international consulting services aimed at making performance based budgeting systems operational in at least two budget offices were organized under a Budget Task Force consisting of the five Directors of Budget.<sup>20</sup> In the successor TA,<sup>21</sup> the task force was to liaise with the Secretaries of Finance and Administration and of Economic Affairs, and the heads of finance and planning departments in the states. This subsequent TA was expected to coordinate its activities with the EMPAT team whose activities are directed by a different national level Steering Committee. The EMPAT team is directed by one committee, which is entirely national level. The Performance Based Public Resource Management team reports to a different task force, none of whose members are on the former Steering Committee, but which has both national and state representatives on it. There is thus some confusion over who is driving the reform program.

The consequences of not comprehensively addressing public sector reform issues at the outset can be illustrated in two ways. The first example relates to the mechanics of government-wide downsizing programs that continue to meet effective service delivery requirements. In the reduction in the number of government departments, in some states, the personnel function has been merged into the responsibilities of Departments of Finance. A strong personnel function usually ensures that a downsizing program does not release staff who are still needed, and that it is applied equitably. It is also assists departments with mergers and reorganizations,

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<sup>20</sup> TA2538, Improved Budget Management Project, approved 14 March 1996.

<sup>21</sup> TA2983, Performance-based Public Resource Management approved 26 January 1998.

makes proposals to ensure that any incentives attached to increased productivity consequent on the downsizing are appropriate, and assists departments to develop human resource management programs to ensure that there is no long term reduction in the quality of public service delivery. Merged into the Department of Finance and Administration, the personnel function becomes subsidiary to finance rather than an equal partner. Evidence for this is the Pohnpei Department of Finance and Administration Secretary's observation that personnel was her third priority. Two years into the program, she would be turning to address personnel issues after she has resolved the state's macro-economic and financial priorities.

A second example relates to the situation of the broad accounting function throughout government. There are few qualified accountants in FSM, reportedly none in Kosrae. Consequently, there is a great need to improve the competencies of accounting staff in government, as there is a dearth of accounting personnel in the private sector. The needs are greater than can be addressed by the training requirements of the two performance based budgeting specialists provided for in the technical assistance project mentioned above.<sup>22</sup>

#### **3.5.4 Effectiveness of monitoring**

Under the oversight of the Vice President of the national government, the PSRP has been monitored by State Public Sector Reform Committees and by EMPAT. The latter reported to a Steering Committee of the Secretaries of Economic Affairs, Finance and Foreign Affairs, and was required to submit quarterly reports to the Bank. Additionally, progress has been assessed through a joint Bank-national government review in March 1998 and Bank missions in July and November 1998. Reports have been presented to the Consultative Group Meetings.

There are simple criteria to judge the performance of a monitoring function. Reports must be timely, accurate and focused on those indicators which relate to success criteria. They should also be sufficiently regular to enable management to ascertain quickly

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<sup>22</sup> Regular auditing of public accounts has been outsourced to one of the Big Six accountancy firms operating out of Guam. Its audits of Kosrae accounts over 9 years notes poor internal controls, transactions not being approved appropriately and a number of other omissions suggestive of poorly operating accounting functions.

that a set of activities is proceeding according to plan. Judged on this basis, performance has been unsatisfactory.

### **3.6 Results**

#### ***3.6.1 Participation and ownership***

There has undoubtedly been significant participation in, and ownership of, the reform process. Painful cuts in state public service workforces and pay levels have been made quickly (see section 3.6.2). Further public service reforms are under consideration, such as a new Public Employment Act in Pohnpei that would place all public servants on three-year contracts. There is a growing recognition that the dependency mentality engendered by decades of high aid levels is detrimental to long-term development prospects.

Nonetheless, there is a danger that the reform process has lost momentum. Political commitment seems to have waned, as indicated by the way in which the national level early retirement program was implemented (see section 3.6.4), the way in which national budget surpluses are used by Congress members for local projects that are not regarded as a priority at state level, the reluctance on the part of some state legislatures to pass required legislation, and a marked dissatisfaction on the part of at least two state legislatures with the program. Some politicians and senior officials talk of the reform process ending or winding down in 1999, and some harbor the hope that Compact funding will be maintained at an acceptable level after 2001. Public support for reform seems to have eroded.

There is now a need for the reform process to be revitalized. In this regard, the post-election summits planned for later in 1999 will be an opportunity for presentation of a vision and an elaboration of comprehensive strategies.

#### ***3.6.2 Public service downsizing and government finances***

Strengthening of government finances is the core of the PSRP, with public service downsizing the primary means (output 1), supplemented by increased domestic revenue generation (output 2). National government departments have been restructured and

reduced in number from 11 to 7, though in a rather ad hoc manner. Government departments in Pohnpei have been reduced from 14 to 7. The major nationwide effort has been in reducing staff numbers and pay levels.

Presenting a clear and precise description of workforce reductions is hampered by differences in the baseline numbers and final target levels reported in the PSRP documentation. This reflects weaknesses in monitoring and reporting already referred to. Nonetheless, data indicate that significant downsizing of public service workforces has been achieved: approximately 25 per cent in Chuuk; between 11 and 17 percent in Kosrae; between 22 and 37 percent in Pohnpei; between 26 and 35 percent in Yap; and between 7 and 24 percent in the National Government. In addition, Chuuk has cut wage rates by 20 percent, Kosrae has imposed a 12.5 percent wage cut, Pohnpei has introduced a 10 percent pay cut following a 20 percent cut for seven months in FY1997, and Yap has restricted overtime and annual leave accrual (though no wage cuts have been imposed).

There is one caveat to the downsizing achievement as far as the national government figures are concerned. This concerns the category of employment that is taken as relevant for the purposes of monitoring and assessment. The category used by the Bank and EMPAT is "FSM Unrestricted Funds", but there is an additional category of "Federal Programs and Refundables". A different picture of what has happened to employment in the period 1995-99 emerges if the total of these categories is considered. The total on the national government payroll has risen from 733 in January 1995 to 807 in February 1999.

It is also important to recognize that local ownership of public service reforms was evident in the fact that substantial staff cuts were made before the implementation of the early retirement schemes, which began with the availability of program loan funds from August 1997. The vast majority of retirements under the schemes thus occurred in calendar year 1998. An up-to-date summary table of retirements by state and for national government is not available; but the EMPAT I draft final report provides numbers as at the end of September 1998: Chuuk 288; Kosrae 107 (plus 50 volunteers awaiting a decision); Pohnpei 146; Yap 75 (all mandatory); National 86 (plus 43 volunteers awaiting a decision). These add to a total of 702 retirees.

The impact of staff cuts on service delivery is unknown, but there has been a reported drop in staff morale as a result of paycuts – and because some public servants have been compelled to undertake two or more jobs while being paid for one. On the other hand, some state government departments are beginning to examine alternative ways of producing services. For example, caretaking responsibilities for schools might be contracted out to local communities in Kosrae.

The PSRP also set targets for revenue increases: 20 percent for Chuuk; 5 percent for Kosrae; 20 percent for Pohnpei; 30 percent for Yap; and 40 percent for the national government. The new Customs Act became effective on 1 October 1997, and was projected to increase revenues from that source by 35-40 percent. The lack of accessible data on actual budget outcomes for FY1997 and FY1998 prevents comment on achievements in this area, just as it prevents an assessment of reductions in recurrent expenditure resulting from public service downsizing. However, the EMPAT I Draft Final Report notes that state taxes and fees in Chuuk in FY1998 increased on FY1997 levels by 24 and 13 percent, respectively; and that they showed a “substantial drop” in Kosrae. Outcomes for the other states are unknown.

### ***3.6.3 Public enterprise restructuring***

The third output of PSRP involves the restructuring of approximately 33 public enterprises and the privatization of some. The EMPAT team has provided assistance in identification of departmental functions that could be corporatized or privatized; and the Performance-based Public Resource Management TA involves the establishment of a framework for monitoring the performance of public enterprises. Some departmental activities have been privatized or contracted out, and the states have transferred power, water and sanitation services to independent public utility authorities, with a view to introduction of a user pays approach to service delivery. Otherwise, there has been little progress. There is a need to develop a comprehensive policy framework and an associated action plan.

### **3.6.4 *The Early Retirement Schemes***

The fourth output of PSRP is the mitigation of the negative social and economic impact of public expenditure adjustment. Tracer studies were supposed to have been done of personnel taking the package, and were provided for under the loan and belatedly under EMPAT II. However, they were not underway in February 1999. Information from the *Island Tribune* and interviews in Kosrae and Yap indicates that packages were consumed quickly, that relatively few retirees accessed training programs once they were available, that few businesses were established, and that the majority of these businesses failed. These conclusions need to be verified by reliable survey data but, in retrospect, the original expectation that “a considerable number [of voluntary retirees] will be younger with the energy, initiative and appropriate education to make a success in the private sector” (paragraph 53, RRP) appears over-optimistic.

Some advantages taken of the spirit of the early retirement scheme at the national level are of concern.<sup>23</sup> Had there been agreement about the core functions of government and the machinery of government to fulfil them, including organizational arrangements that reduced the opportunities for one individual to be in a position to grant a favor to another individual, it is unlikely that such a concern would have arisen.

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<sup>23</sup> By 15 January 1999, 90 national government servants had taken the retirement package. Among them were the Attorney General, the Director of Court Administration, the Chief Public Defender, the Chief Clerk, a Commissioner of Revenue, a Chief of Immigration, and the National Planner. One of the conditions of a person taking the package was that his or her job was regarded as redundant. The Attorney-General's Department lost its head, the Attorney General, the head of that part of the department responsible for running the federal courts, the Chief Public Defender and the Chief Clerk. Surprisingly, the December 1998 listing of national public servants includes a Secretary, Department of Justice, a Director of Court Administration and a Chief Clerk. There does not appear to be a Chief Public Defender, the office of which is staffed by two contract consultants. It is reported that the former Attorney General, who is not a permanent public servant but is appointed by the President for the lifetime of the present government, is now receiving contract work from the Government.

### **3.6.5 Private Sector Development**

The fifth output of PSRP is fostering the development of the private sector. Two notable changes have occurred. First, there has been a liberalization of interest rate controls. Second, a new Foreign Investment Act came into effect on 1 January 1998, and complementary legislation has now been passed by all of the states. This will potentially improve the investment climate by separating national and state jurisdictions over granting of foreign investment permits, streamlining and shortening the approval process, and automatically providing expatriate worker authorizations. There has been a number of recent private sector investments in tourism resorts, tuna long lining, and apparel manufacture. However, for potential improvements in the investment climate to be realized, a number of constraints need to be eased. "The biggest constraint to increased foreign investment is the continuation of a very high level of government interference with the commercial sector" (Business and Government Strategies International, TA No. 2786-FSM, Investment Promotion and Financial Sector Review, 20 November 1998). Other constraints include uncertainty about future economic stability, pending the outcome of Compact negotiations; problems in gaining secure and transferable access to land; inadequate, high-cost transportation links; inadequate physical and social infrastructure; and small market size.

In the meantime, contraction of the public service has caused a contraction in the private sector because so much private sector activity depended on sales to the public sector. The absence of national accounts after 1996 prevents quantification of the aggregate outcome.

### **3.6.6 Governance**

In a democracy like FSM, reform programs, if they are to be successful, need to be nurtured over a number of years, years often well in excess of the conventional term of one government. It is unhelpful if, as has happened in Kosrae, the reform program is an election issue and those perceived to be associated with the program fail to be re-elected.

In the FSM reform program, there have been few if any "wins" for the state political leaders to demonstrate to the electorate that,

while the pain was necessary, there were also some gains. No provision was made in the program to maintain an effective media campaign to explain the necessity for the reforms as positively as possible. With little attention being paid to improved services, the outcome was one of unremitting pain. Opportunities to alleviate this through a judicious use of the national level budget surpluses were dissipated on projects of particular interest to the national level politicians.

The impacts of the program lie in three broad areas: impacts on government budgets, impacts on the quality and cover of service delivery, and impacts on individuals directly affected by the changes. Not surprisingly, with a predominant focus on reducing costs to balance the budget, there has been a strong focus on the first of these impacts throughout the program. There has been no attention to the impacts on service delivery, other than the recent attention to the introduction of performance criteria in the budget papers. Service priorities and departmental operations to deliver particular services were not addressed at the design stage, and consequently capacity building at the service delivery level has been neglected. It appears that the majority of lower paid retirees were under-prepared for the change. For those who decided to remain in public employ, there are no studies of the impacts of the program on their work and productivity. Again, it appears that there is resentment at the changes to their conditions of employment, accompanied by a perception of an increase in job requirements.

The organizational arrangements whereby the Bank-funded EMPAT and performance-based budget teams report to two different committees with quite separate memberships make the location of responsibility for managing and driving the reform program unclear. An effective reporting system has not been established, despite the fact that technical assistance accompanying the loan was specifically set up to improve the monitoring of the social and economic impacts of the overall economic reforms. This situation needs remedying immediately.

A national champion with broad-based support and a mechanism for driving the program are not apparent. As noted above, the evidence suggests that the National Government has circumvented the key requirement of reducing staff numbers.

The reform program has paid little explicit attention to governance issues. In terms of accountability, the mechanisms for an

effective system are in place. The diminution of the system probably lies in the inexperience of legislatures of what their roles are and how to exercise them. The two legislative bodies that the review team had access to both contained speakers and other members who were very keen to exercise their responsibilities effectively. Both States had expatriate legal advisers. What both needed was a development program to enable legislative members to conduct their review functions more effectively and to be appraised of the kinds of powers that they can exercise. Only then would there be an appropriate balance between the legislative and executive branches of government.

### **3.7 Looking to the Future**

In sum, PSRP started well, with a sensible basic design given the urgency of bringing the fiscal situation under control. Governments have made considerable progress in implementation. But design was less strong on establishing effective internal mechanisms to ensure that momentum was maintained. Participation at the outset was good and would have been enhanced if there were a better mechanism to institutionalize it through the political process. The design also ignored the important point of making the program politically as palatable as possible by providing some wins, and by ensuring that there was an effective media campaign to continue to promote the importance of the program to the future of FSM. The program design did not do enough to change the focus of the EMPAT team to include public service delivery alongside its economic foci. Nor did it do enough to ensure that State governments were supported with at least the same level of independent advice as their national colleagues, and that there were mechanisms to distribute surpluses to ameliorate some of the negatives of the reform program, should such surpluses occur.

Now the reform program seems to have lost its way. Commitment and support for the program need to be strengthened. The political key to reigniting the reform process is the threat of the Compact re-negotiations. FSM has now had one experience of the pain of a significant cut. The potential future pain, promoted on the basis of something like a zero-based budgeting exercise, could present a concentrated focus for the electorate that pressure needs

to be maintained on the public sector to reduce costs, improve productivity and deliver on a service delivery charter. The scenarios can be produced by the EMPAT team. It will probably require support to help convert the messages into coherent and effective political action. Completion of a reignited reform process will require not only further public service reform (as opposed to simple downsizing), but also translation of the commitment to public enterprise reform into a coherent policy framework with an associated action plan, and ongoing improvement of the private sector policy environment.

Key lessons that emerge from the FSM reform experience are:

- Public sector reform is more difficult than simple fiscal constraint. It should be planned at the design stage by experts in public administration in a small developing country context, identifying clear end points for the reform program, some of which must represent definite benefits.
- Retrenchment programs should be components of a public sector reform program, and thus be based on a clear specification of the desired future form of government. They should be designed with reference to local culture and make effective provision for education on managing life after retrenchment.
- Where retrenchment is elective, strong mechanisms are needed to ensure that it is applied according to the design and intent of the program.
- There should be consistency between program goals and actions taken (reference the use of surplus revenue at the national level for politically-motivated projects).
- Other key factors in a successful reform program include:
  - a high profile champion.
  - a mechanism to drive the program (which is usually the budget).

- organizational arrangements for technical assistance that fit in with the above mechanism (a popular arrangement being a Cabinet level “razor gang”).
- good synchronization between the champion, the driving mechanism and the political process in the sense that the political process is used to endorse and reinforce the need for actions taken.
- an effective public relations campaign to promote the program and emphasize the need for it and the achievements of it.
- identification of clear and relevant performance indicators and a regular and effective program of reporting.
- a participatory/accountability mechanism for the governed to keep the governors on track.