

Chapter 6. Economic Policy in Light of Amended Compact

6.1 Economic and Financial Provisions of Compact: Comparative Analysis

Negotiations regarding amendments to the Compact of Free Association, which focused primarily on the financial provisions, were completed in May 2003. After review and approval by the respective legislatures, the amended Compact was formally ratified in June 2004. In October 2003, interim procedures were approved for implementation in early 2004.

Under the terms of Compact II, budgetary transfers are replaced by sector grants designated for specific purposes jointly agreed upon by the FSM and US governments. Six sector grants are specified: (1) Health, (2) Education, (3) Infrastructure, (4) Capacity Building, (5) Private Sector Development, and (6) Environment.

In the new Compact, the real value of annual grant assistance is substantially lower than at the end of Compact I. The assistance package includes an annual US contribution to a jointly-managed trust fund, the earnings from which are intended to replace annual grant assistance beginning in 2023, the end of Compact II. The annual grant amount under the new agreement, before inflationary adjustment, is \$76 million for the initial years (fiscal 2004-2006, Table 13). Beginning in 2007, the annual grant amount will decline by \$800,000 annually. This amount will be added to the annual trust fund contribution.

**Table 13. Compact II Grant Assistance:
Fiscal 2004-2023 (in Millions of US\$)**

	Annual Grant	Trust Fund Contribution	Audit Grant	Contribution to Disaster Fund	Total
FY 2004-06	76.0	16.0	0.5	0.2	92.7
FY 2007-23	75.2 - 62.4	16.8 - 29.6	0.5	0.2	92.7

Source: Compact of Free Association, as amended.

There is still access to US program assistance under Compact II, except that certain education programs are replaced by an annual cash grant intended to allow the FSM to develop similar projects. The terms under which the services of various US agencies are provided were renegotiated.

The new terms and conditions of Compact II include a substantial increase in US involvement in programming and monitoring the use of grant assistance. Under Compact I, US concurrence was required only for the use of the special grant for health and education. The allowable uses of funds designated for capital expenditure were subject only to a list of expenditure categories. The reporting requirements, being limited to an annual report, were minimal.

Box 8. The Supplemental Education Grant

During the initial 17 years of the Compact relationship, US domestic programs provided substantial amounts of technical and financial support to the FSM, particularly in the areas of health and education. With respect to the education sector, federal programs accounted for an average of more than 21% of total expenditure between 1996 and 2000. This included a combination of grants that were awarded on a competitive basis (competitive grants) and amounts specifically designated for use by the FSM (formula grants).

The new Compact arrangements contain important changes in the way many services are funded. Most formula grants will be replaced by the new Supplemental Education Grant (SEG). The FSM will continue to be eligible, on a competitive basis, for a wide range of US domestic programs. The rationale for the change, which takes effect in fiscal 2005, is to allow the FSM the flexibility to develop programs that are better adapted to its needs.

FSM FY2005 Proposal for Supplemental Education Grant

	National	Chuuk	Kosrae	Pohnpei	Yap	Total
Freely Associated States						
Education Grant	0	794,586	796,094	777,842	611,248	2,979,770
Vocational Education						
Improvement Program	0	140,000	140,000	140,000	140,000	560,000
Workforce Investment						
Act	281,474	658,884	100,253	448,429	147,216	1,636,256
Head Start Program	0	2,498,532	110,000	1,851,788	1,348,641	5,808,961
Adult Education						
Program	100,000	0	0	0	0	100,000
College Work Study						
Program	174,331	0	0	0	0	174,331
Supplemental Education						
Opportunity Grant	95,937	0	0	0	0	95,937
Other	75,745	337,389	96,747	224,722	140,222	874,825
Total	727,487	4,429,391	1,243,094	3,442,781	2,387,327	12,230,080

Unlike other Compact II grants, the SEG is funded through a discretionary appropriation, the value of which may vary from year to year. This is a significant change, as the value of programs under the previous formula grants was generally known in advance. It also moves some activities that had previously not passed through FSM governments to the state and national budgets. Head Start programs had previously been managed by state-level NGOs, while College Work Study and the Supplemental Educational Opportunities Grant were paid directly to students.

The initial FSM proposal for the use of the grant was based on the programs it was intended to replace, and the historical level of services and funding. One problem in determining the level of funding is that it does not consider benefits received under the College Work Study and the Supplemental Educational Opportunities Grant by FSM students studying in US institutions, due in large part to the lack of information on the amount of these payments.

Compact II continues to give high priority to education. The major changes made in the terms for providing grant assistance for education and training reflect this policy. These are summarized in Box 8.

Grant assistance under Compact II is administered by the Joint Economic Management Committee (JEMCO), which consists of three members designated by the US and two by the FSM. This committee is specifically empowered to determine the allocation of the main sector grants, and has also become the vehicle for programming the SEG. Quarterly and annual reports are required, with an understanding that reports will include the use of performance indicators to assess progress. The programming and management of the grants should be consistent with the goals contained in the Strategic Development Plan prepared in conjunction with the Third Economic Summit.

In the future, the FSM will be obligated to prepare or maintain an updated development plan that meets the requirements of Compact II. The FSM governments must prepare proposals for the use of the sector grants as part of the overall budget preparation process. The amount of funding available is given at the aggregate level – specific levels are not assigned to the individual grants. In practice, the US has typically approved financing for virtually all activities in the health and education sectors, while calling for the phasing out of funding for recurrent expenditure in support of governance. Another priority sector under Compact II is infrastructure, with much of this funding earmarked to support education and health. Other sector grants, can be expected to account for a relatively small share of total available funding.

6.2 Strategies and Policies for Achieving Sustainable Development

The FSM has committed to the improvement of public sector governance, including changes in the management of public sector enterprises. As part of the ADB-supported Private Sector Development Program, the FSM will transform a number of enterprises and activities currently owned and operated by the public sector. This would include taking steps to privatize, or contract to the private sector the management of enterprises or activities delivering goods and services to intermediate and final demand markets (including services that are paid for by government, e.g., food service in schools and hospitals). Making good on this commitment constitutes an important element of an overall government policy towards private sector development.

6.2.1 Strategic Development Plan

The FSM's current strategic planning process evolved from the need for a more flexible framework to facilitate the design and implementation of the Public Sector Reform Program. The strategic planning framework will include a set of long-term goals for each of the sectors, as well as a listing of medium-term objectives and strategies. While the long-term goals will tend to remain the same over time, the specific activities will be updated periodically. The ultimate objective is to create an explicit linkage between the development planning and budgeting processes.

The goals and objectives of the initial Strategic Planning Framework were developed in the Second Economic Summit. Documents were prepared for each of the sectors in advance of the summit, including descriptions of key issues and proposed strategies. Summit participants then worked to develop sectoral matrices that associated broad strategic goals with more focused objectives and activities.

The provisions of Compact II require the FSM to prepare and submit a development plan to the US that is *strategic in nature and continuously reviewed and updated through the annual budget process. It shall identify the goals and strategies of the Government of the Federated States of Micronesia to promote economic advancement, budgetary self-reliance, and economic self-reliance, and contain specific multi-year objectives for the sectors described in section 211(a) of the Compact, as amended.*

The Third Economic Summit in March 2004 was convened primarily to prepare the sector level Strategic Development Plans (SDPs) and Strategic Planning Matrices (SPMs) that would fulfill the Compact II sector plans requirement. The agriculture and fisheries SDPs were prepared along with this report.

The main objectives of the Summit were to: (1) build awareness of the economic structure of the amended Compact provisions and the likely impact on the economy; (2) achieve consensus on an overall strategy consistent with the theme of achieving economic growth and self-reliance; and (3) improve implementation and monitoring of the outcome of the planning process.

The extent to which the Summit accomplished the three objectives is debatable. Certainly, among the approximately 400 participants at the Third Summit, the first and second objectives were at least nominally accomplished, as indicated by the principal resolution that endorsed the high-growth strategy.

The overall Strategic Development Plan, which was completed by the beginning of fiscal year 2004, was submitted to the FSM Congress for approval in January 2005. The Third Economic Summit accomplished the task of drafting Sector Planning Matrices (SPMs) for eight sectors: private sector, agriculture, fisheries, tourism, environment, health, education, and gender. However the SPMs for agriculture and fisheries, as well as the Macroeconomic Framework of the SDP, were not finalized until January 2005.

Having completed most of the work of preparing the SPMs, the Summit was presented with three economic scenarios that the FSM could face in the next 20 years, the period covered by US Compact II grant assistance. The scenarios were: (a) the “dismal” scenario; (b) the “moderate growth strategy” scenario; and, (c) the “high-growth” scenario. The last was subsequently renamed the “sustained growth strategy.” Each scenario assumes the presence of a policy environment and commitment to reform that enables economic growth and development. However, in the dismal scenario, problems in implementing the infrastructure grant result in low levels of investment. It is also assumed that the policy regime remains essentially the same. This scenario represents the status quo development projection – essentially nil growth of real GDP over the 2004-2023 period.

The “moderate” growth strategy will result in little growth of per capita real GDP over the 20-year Compact II period, averaging less than 1.0% per annum. The modest growth scenario assumes governments’ adoption of a reform agenda, but with less commitment than in the sustained growth scenario. For example, although the foreign investment climate has improved, reform efforts are weak with respect to public sector enterprises. Agriculture sector growth is projected at only 2.5%, but little growth occurs in the fisheries sector because important PSE reforms are not implemented. Tourism improves significantly in this scenario with at least a five-fold increase projected in visitor arrivals from 21,000 to 110,000 by 2023.

The sustained growth scenario assumes that FSM governments follow a rigorous reform agenda with the private sector as the main focus. An improved regulatory regime brings about a drastically improved foreign investment climate. Reform of the PSE sector is also vigorously pursued with most non-performing enterprises being privatized, or liquidated. Access to land is improved, and legislation is enacted that supports long-term leases and mortgages.

In the sustained growth scenario, real per capita GDP (in 1998 \$) is projected to rise to about \$3,200 by 2023, from an estimated \$1,950 in 2004. This entails real growth averaging about 2.6% per annum. With respect to the main productive sectors, this scenario assumes significant growth in agricultural exports (\$12 million in 2023) and a fisheries sector projected to expand by four-fold by 2023 (roughly \$100 million in 2004 dollars). Tourism is the leading sector under the sustained growth scenario, with 110,000 projected visitors by 2023 (generating roughly \$137 million in 2004 dollars). To achieve this, private investment would have to increase from the currently estimated 7% of GDP (about \$16 million based on 2003 GDP) to a projected level of 17%.

This question of whether this strategy can be implemented is critical. If the SDP does not have the support of the political leadership in the states and at the national level, then the policies and strategies of the Plan will not be implemented, even if the resources are available.

There needs to be renewed effort to obtain commitment from the political leadership to authorize and follow the recommendations and decision-making of EPIC, or another body that would fulfill EPIC's role in marshalling consensus across the five governments in adopting the Strategic Plan. The record thus far on the effectiveness of EPIC is not encouraging (see Box 9).

While economic planning at the national level has had considerable support from the donor community (e.g., EMPAT in the DEA), relatively little assistance has been received by the states. At both national and state levels, strategic planning capacity has not been institutionalized. Little progress has been made in building ongoing planning capacity, even at the national level. With the end of the EMPAT project in December 2004, the FSM lost critical capacity just as the nation was faced with the major challenge of transitioning to Compact II.

The SDP was structured and prepared for FSM-wide implementation, necessitating "translation" to the state level in terms of disaggregating strategic outcomes, activities, and outputs. This is clear from the sector SPMs. In the case of tourism, for example, the SPM specifies that "*all states produce a 10-year tourism development plan by 2006....* Given the degree of autonomy afforded the states under the FSM Constitution, nationwide development planning must include specific institutional linkages between national and state planning agencies and

Box 9. Government Endorsement of Policy-Related Outputs of the Summits and EPIC

In the aftermath of the first two Economic Summits, some leaders within the FSM governments questioned whether the summit's policy and planning outputs truly represented the development policy of the FSM. Legislators in some of the governments indicated that even though the executive branch had endorsed summit policies, they had not been approved by the legislatures. Some senators in the National Congress also questioned the legitimacy of the initial Strategic Development Framework on the same basis.

The establishment of the Economic Policy Implementation Council (EPIC), following the second Summit in 1999, was probably intended to address this issue. This body included the chief executives of all the governments, and the presiding officers of all of the legislative bodies. Nevertheless, the resolutions coming out of the EPIC meetings did not legally bind the participants, and the record of subsequent legislative implementation of the decisions has been mixed at best.

In recent years, there has been a move towards seeking explicit legislative endorsement for key policy documents. This was done for the Infrastructure Development Plan, and is now being done through the legislative budget process for the decisions of the US-FSM Joint Economic Management Committee.

professional-technical capacity for strategic planning and performance budgeting.

Another critical issue relates to the infrastructure development plan (IDP). Although the SDP planning papers prepared for each sector were to explicitly consider infrastructure needs, the IDP was prepared separately. The strategic planning process must integrate infrastructure investment with sectoral planning. This is currently not the case in the FSM. Under Compact II this would be the Project Management Units (PMUs). The PMU approach was first proposed in the report by Nathan Associates, from which a large portion of the IDP was drawn. Discussions regarding the PMU are ongoing. Its structure is likely to include a central office in the national government and project managers in each of the state governments. Part of the funding will come from the Compact infrastructure grant since 15% of the value of each project can be added to total project costs to cover PMU operating expenses.

A key element of the FSM negotiating position was the role of performance-based budgeting and management in providing a link between planning and expenditure. Progress has been made in establishing the technical components of the performance budgeting system and training mid-level staff in using the software, but higher-level professional capacity in using the system for planning, budget preparation and performance monitoring is still lacking. Governments

need to renew efforts to move forward with full implementation of performance budgeting and its integration with strategic planning, in both executive and legislative branches.

6.2.2 Reform of the PSE Sector

The top-heavy public sector structure was a carry-over from the US Trust Territory administration. In the early years of the Compact, government involvement was deemed necessary, based on the belief that large-scale investments were required to establish viable enterprises and that the local private sector was not capable of such commitment. In early 2000, the Aries project determined from interviews that the annual wage bill for formally constituted PSEs amounted to an estimated minimum of \$2.7 million per annum for the 2,073 people formally employed.

A total of 26 enterprises and 25 or more commercial activities have been identified. These generally fall within one of four distinct categories: (1) units or activities that carry out the functions of an enterprise or engage in commercial activities through a government department or agency created by statute; (2) PSEs that carry out enterprise functions through an authority created by statute and which are owned and operated by the state; (3) PSEs that carry out functions of an enterprise through a public corporation created by specialized statute without share capital and that are wholly owned and operated by the state; and (4) PSEs that carry out the functions of an enterprise through a private corporation organized under the Companies Act and whose shares are held in whole or in part by the state.

At the same time, governments gradually privatized various services that had been part of government agencies under the former Trust Territory administration and during the early years of the Compact. Beginning in the early 1990s, the public utility services were moved out of the public works departments and transformed into independent corporations, albeit with continued state ownership. Electrical power generation has also followed this system but corporatization of the water system in Kosrae has lagged behind due to public resistance to water charges and the existence of many small water systems. Similarly, the ports and airports in Kosrae and Pohnpei are now operated by independent authorities which are overseen by boards composed of political appointees.

All of the economic summits resulted in policies that strongly endorsed the need to reduce government involvement in market-oriented enterprises and activities that could be more efficiently operated either on a strictly commercial basis, or through some form of privatization. In some cases, the closing of operations

was recommended. An important step in advancing overall public sector economic reform, following the First Summit, was the specific focus given to the PSE sector. An ADB project, TA No. 3201, was initiated in October 1999 to assist the FSM in formulating a comprehensive program for privatization and corporate governance reform of public sector enterprises. The project, commonly referred to as the Aries Study, included three broad policy objectives: *(1) promote more efficient operations through corporate governance reforms and de-monopolization and exposure to competition in order to reduce the need for State subsidies; (2) spread and encourage local ownership through disposition either in whole or in part in order to enlarge the private sector; and, (3) obtain the best value possible taking into account the interests of all stakeholders in the event of disposition.*

The scope of work of the Aries study included taking a comprehensive inventory of all PSEs, both national and state-owned; preparing an in-depth analysis of ten pilot PSEs targeted for corporatization and/or privatization (including a transformation plan); and the preparation of a model Five-Year Master Plan, and a one-year, Action Plan for a Public Sector Enterprise Unit (PSEU). The PSEU was to be instrumental in managing and coordinating implementation of the PSE program.

Upon completing the inventory, the Aries project submitted a list of proposed pilot PSEs for transformation, two in each of the five governments. In early 2001, the project submitted a preliminary master plan for the reform of all PSEs.

There is substantial financial, administrative and legal work entailed in achieving the transformations. For this reason, the follow-on work envisioned for the Public Sector Enterprise Unit (PSEU) is critical and was addressed in terms of its recommended organizational structure, including duties and responsibilities and staffing requirements. Duties and responsibilities of the PSEU include: (a) working with outside consultants to implement approved Transformation Plans as directed by the Public Enterprise Reform Committee (PERC); (b) coordinating with the state counterparts on the preparation of Enterprise Transformation Plans for state enterprises; (c) providing assistance to state counterparts and coordinating with the states and outside consultants involved with the implementation of the program; (d) monitoring the performance of the public enterprises from the latest financial statements available and provide the PERC with reports on their performance and impact on national and state budgets; and (e) formulating a Multi-Year Master Plan and Annual Action Plans (for transformation of enterprises). The PERC is the high-level decision-making committee on Public Sector Reform Program chaired by the FSM President or Vice-President. The Committee is responsible for approval of Enterprise Transformation Plans.

Clearly, the work of the PSEU will be substantial and critical to the success of the Public Enterprise Reform Program. The importance of this reform program is underscored by the level of support provided by the ADB. It endorsed in part the recommendation made by the Aries project to fund a long-term advisor to *provide continuity to identify and oversee the performance of a number of tasks in order to tackle the numerous specialty challenges arising out of this program.*

At the time of this report (March 2005), planned public sector enterprise transformations in the four States had been adjusted to one in each state rather than the two originally planned. No PSE transformation has actually taken place. With respect to the PSEU, the Secretary of the DEA has assumed the position PSEU unit head, and neither the full-time financial analyst, nor the part-time lawyer have been employed.

Although progress in privatizing, commercializing, or divesting the PSEs has been disappointing, there has been some progress in reducing the level of operating subsidies, as shown in Figure 7. However, there are still many PSEs that continue to operate inefficiently and effectively preclude (because of subsidization) the market entry of private enterprise. Some SOEs continue to operate at a loss by drawing down invested capital, and direct and implicit subsidies continue to adversely impact government budgets. As indicated in Figure 7, the direct subsidies alone still account for about \$4.0 million per annum (implicit subsidies are not included in the subsidies and transfers shown in Figure 7).

6.2.3 Private Sector Development

In the seventeen years of receiving large-scale economic aid under Compact I, there has been modest progress in building a larger private sector, both in terms of GDP and employment. Table 14 indicates the relative shares in GDP and employment for the four institutional sectors in 1987 and 2003. A similar table was presented and discussed in Section 5.2.1.

Figure 7. Government Subsidies and Capital Transfers to Non-Financial Public Sector Enterprises

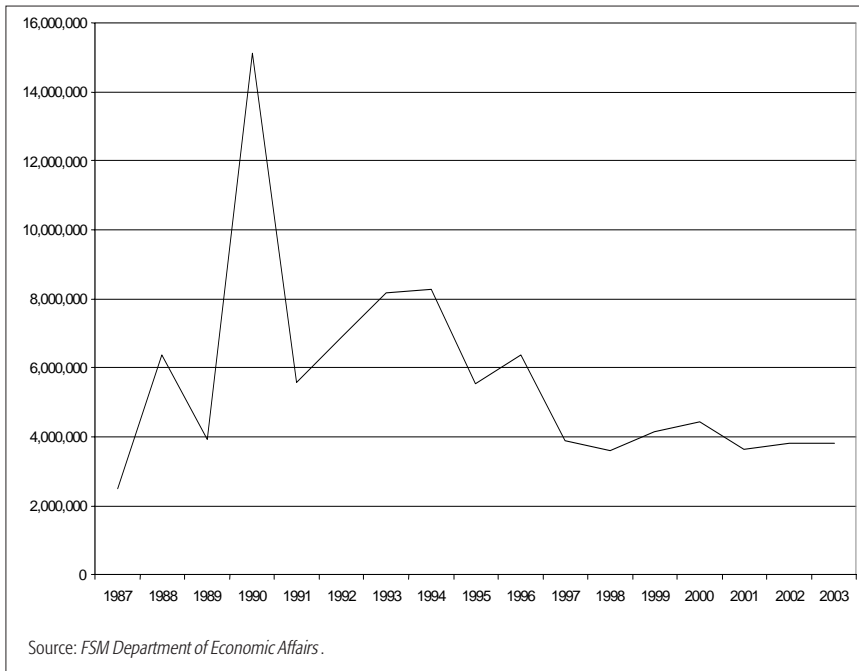


Table 14. Sector Shares of GDP and Formal Employment: FY1987 and FY2003

Sector	1987		2003	
	GDP Percent ^{1/}	Employment Percent	GDP Percent ^{1/}	Employment Percent
Private	34	29	41	42
Government	57	60	40	42
PSE	4	2	12	6
Non-Profit	5	9	7	10
Total	100	100	100	100

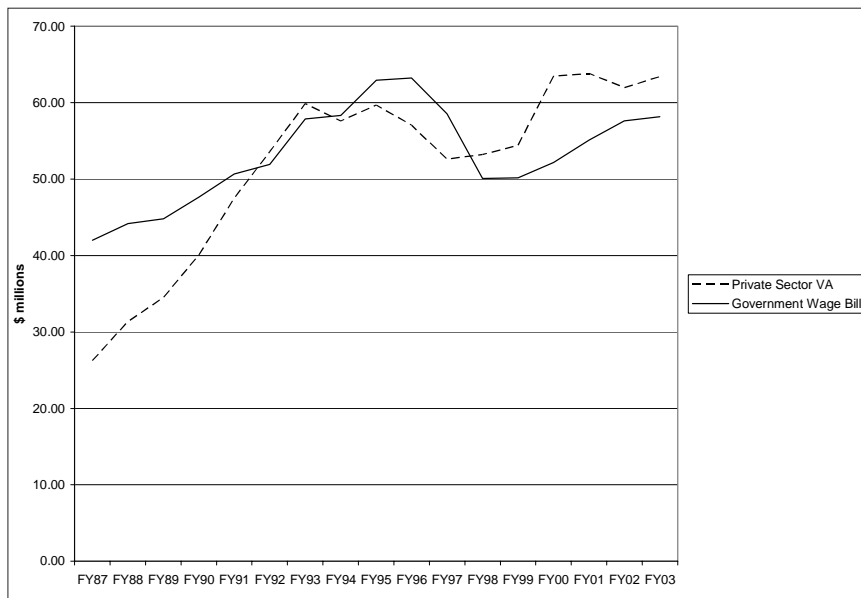
Source: FSM Department of Economic Affairs. 1/ - Only relevant components of GDP are included for comparisons.

Throughout the Compact I period the level of private sector activity in the FSM has been driven in large part by the level of Compact transfers and government expenditure. This is illustrated in Figure 8.

Given the significant decline in Compact II grant assistance and the fact that in real terms the decline will steadily continue to 2023, the FSM will have to do more towards increasing the size of the private sector. This restructuring will facilitate an increase in tax base and productivity and will enable a rise in share of tradable goods output, all key elements needed to raise the standard of living and economic self-sufficiency. In the overall FSM development context, private sector is explicitly meant to encompass all non-governmental organizations whether or not they are profit-oriented.

Although the size of the private sector has increased modestly, the structure has not fundamentally changed since the mid-1990s. Expansion has occurred almost exclusively in the non-traded goods sector of the economy, i.e. in the retail and wholesale sectors and services activities (e.g., repair and maintenance, residential and commercial construction related mainly related to retail and government demand, and communications) and not to the main productive sectors in the FSM – agriculture, fisheries, and tourism. It is these latter sectors that include the production of tradable goods and services that

Figure 8. Relationship Between the Government Wage Bill and Private Sector GDP Growth



can compete with overseas suppliers (e.g., food commodity imports, processed/manufactured items) or in overseas markets (e.g., tourists to FSM, regional and international fisheries and agricultural commodity exports).

The Second Economic Summit identified a number of specific factors limiting private sector growth, including:

- *Excessive government intervention in productive sectors as opposed to removal of business constraints;*
- *Greater public sector employment opportunities and higher relative wages;*
- *Skill limitations;*
- *Dependence on government rather than commercial financing for development;*
- *Evolving land tenure systems (that include constraints to economic development, including inefficient land markets, restrictions on leases, slow titling and registration, and limitations on use of secured loans);*
- *Variable transparency and efficiency in the business and investment environment;*
- *Protective attitudes towards foreign investment;*
- *Variable infrastructure and transport limitations that undermine private sector growth and competitiveness; and,*
- *Transport constraints and high fuel costs (affecting international access).*

The Second Summit reviewed efforts to address these limiting factors. The initiatives included the PSRP aimed at downsizing government and restraining the wage bill, creating an enabling and regulatory environment to facilitate private sector development (revisions of codes related to foreign investment, secured transactions and taxation), changing attitudes to foreign investment, revising land titling procedures, and extending leasehold terms in some states.

Policy elements endorsed by the Second Summit with respect to private sector development included:

- (1) Commitment to economic reforms
 - Macroeconomic policy that fosters fiscal responsibility
 - Maintenance of financial stability
 - Limits on size of government and development of public accountability
 - Consistency of tax regime with private sector-led development strategy

- (2) Outward-looking approaches to economic development
 - Make tax regime consistent with outward-oriented economic strategy
 - Encourage investment in priority and potentially competitive export growth industries
- (3) Lower costs, improve performance and develop competitive markets for the means of production
 - Ensure labor is wage competitive by reducing public/private sector wage differentials
 - Increase labor productivity and competitiveness
 - Direct human resources development investment towards skill gaps for priority growth industries
 - Make land more readily available to those who need it for sound development
 - Facilitate the use of land as collateral to increase availability of development financing
- (4) Reorient public agencies and administration to facilitate private sector development; decrease the cost and increase the ease of doing business; promote good governance; and, minimize government involvement in commercial and service activity
 - Develop a business-enabling regulatory environment that promotes a private sector capable of generating long-term economic value
 - Foster a corporate climate which respects the interests of stakeholders and society
 - Focus support on competitive tradable goods and services
 - Focus on efficient, coordinated support services providing information, advice and training – not subsidized finance
 - Allow the market to determine the value and commercial viability of state-owned productive enterprises earmarked for privatization

Now that the FSM is well into fiscal year 2005, the second year of Compact II, it is possible to briefly review the progress made in addressing the main constraints to private sector development that have been identified in the economic summits. Discussed here are: (a) commitment to economic reforms in support of private sector development; (b) access to land; (c) labor market inefficiencies; and (d) enabling environment.

6.2.3.1 Commitment to Economic Reforms

Studies conducted in the Pacific Islands region and in developing countries around the world affirm the importance of an appropriate policy framework and pro-active commitment to working with the private sector to create a favorable business and investment climate. Strength of commitment is the key to success in building a private sector that is outwardly competitive and capable of sustained growth. These are elements critically needed to enable the nation to adjust to the diminishing aid provisions of Compact II.

While government commitment is important to all components of a comprehensive PSD strategy, this section focuses mainly on encouraging private investment, both domestic and foreign. As noted in the Third Economic Summit:

“Experience has shown that foreign investors tend to require a significant period of policy reform “coherence” before they become sufficiently confident that improvement will be long-lasting. It may be the case that recent policy reform stagnation (and even some back-tracking) has made domestic investors somewhat skeptical that FSM policy makers will, in fact, follow a coherent economic strategy.

For the private sector to confidently invest and create new jobs, their perceptions about governance need to be effectively addressed. Through an improved public-private dialogue four positive outcomes can be achieved: (i) private sector perceptions can be comprehensively addressed; (ii) misperceptions and misinformation can be corrected; (iii) information on actual improvements and policy objectives can be shared; and (iv) emerging issues can be addressed collaboratively.”

Potential investors are more likely to commit to opportunities in which the costs of doing business are reasonably predictable. Transparency of regulations, security of transactions, and access to factors of production at reasonable cost, are factors that permit the investor to determine their risk-return situation. This increases the likelihood of achieving an acceptable return on investment.

There are weak communications, little interaction, and a significant degree of mistrust between the government and the private sector. There has been no formal program for government to interact on a regular basis with the business (and civil society) community to discuss outstanding issues perceived to be detrimental to operating profitable businesses. Government needs to provide this venue. Specific mechanisms need to be created for involving the business and civil society in regularly scheduled national and state workshops or

conferences organized to enable participation and input into economic planning and policy-making.

Very little foreign investment has been attracted, not only because of the high-risk business environment, but also because of non-transparent and essentially non-accommodating provisions included in the foreign investment statutes and regulations. As noted in the Third Summit, even though *Foreign investment laws were reformed as part of the reform program in 1997-98 to remove overlapping jurisdiction at the national and state levels. Implementation of the reformed laws through regulations reduced the intended effect and left a large degree of bureaucratic discretion and lengthy case-by-case reviews for many applicants.*

In 1999, the Foreign Investment Advisory Service (FIAS), a joint service agency of The World Bank and the International Finance Corporation, conducted a review of FSM national and state foreign investment legislation. In its review, FIAS noted the practice of the national and state governments to develop lists which categorize sectors and give particular options to investors. The first is the red list which specifies sectors reserved for citizen investments. Second is the amber list in which a foreign investor must obtain a permit and fulfill the specified conditions. The third category contains sectors in need of foreign investment. In this third list, investors need to secure a permit but may operate without conditions.

FIAS's review pointed out that sectors or activities on the amber list should clearly specify the attached conditions (for each activity or sector) and they must be transparent and publicly listed. The intent of the foreign investment law should be to make the issuance of a foreign investment permit (FIP) a simple registration process. This enables the investor to know before applying whether or not he will qualify for the permit, and what conditions (if any) will have to be met.

6.2.3.2 Access to Land

From an economic development standpoint, difficulties in gaining access to land for business purposes translates into increased cost of doing business and higher risk in achieving an acceptable return on investment. This is especially true for foreign investors and many FSM citizens wanting to start businesses in states other than their home state. While land occasionally may be leased, even this is difficult given traditional values towards keeping title and use rights in the clan (refer to Chapter 3 discussion).

Each state has jurisdiction under the FSM Constitution to legislate and regulate land transactions, and therefore each state has distinct laws governing the sale, lease, registration and transfer of title to land. In most states, long-term leases can be obtained if an investor can find an available land parcel. However,

in the case of Pohnpei, land lease terms are limited to 25 years, a term too short for most large capital investments. To mitigate this problem, legislation was passed by Pohnpei State to allow a 55-year lease provided the lessee meets certain conditions for making capital improvements within 5 years (see Chapter 3 Box 4 on Pohnpei Development Leasehold Act provisions). However, the conditions specified under the law apparently are perceived as excessively burdensome, discouraging the use of this lease option.

While the Deed of Trust can be used in some states in conjunction with leaseholds, it is seldom used because of unfamiliarity and because of difficulties resulting from ownership challenges. As most privately-owned land in the FSM is still collectively held by the clan (i.e., not formally registered in individual title), the risks involved in leasing or buying land are high because of the uncertainty of obtaining a valid title or lease rights. Also, in the absence of price data on sale or lease transactions (in part because land is seldom leased or sold), it is difficult for investors or buyers to determine the value of available land.

Implementing more workable land tenure and mortgage financing laws and regulations is an important objective of the current PSD program. With appropriate commitment on the part of FSM governments, new or amended laws and regulations making it easier for investors to obtain land (and use of land for mortgage secured finance) would significantly contribute to promoting both domestic and foreign investment.

6.2.3.3 Labor Market Inefficiencies

Although the FSM is not affected by labor-industry discord – as there are no unions and governments, along with the COM, represent the largest employers – the large differential in salary rates between government and the private sector constitutes a major structural inefficiency. The ratio of average wage in Government to that in the private sector was nearly 2:1 at the beginning of the Compact (1987-1990) and actually increased to 2.08 to 1.0 in the 2000-2003 period. This discrepancy has acted as a major distortion in the FSM labor markets, attracting the most skilled and educated to government jobs. This has had the effect of lowering the competitiveness of the private sector, not only because of the lower skills and education of the remaining labor pool but because of the pressure on the private sector to raise rates to compete with government. Excessively high wage rates is a government pay structure the FSM carried over from the Trust Territory era, but is also a result of the large grant transfers flowing into government treasuries in the initial years of Compact I. It has also profoundly affected agricultural and near-shore fisheries production which has largely stagnated during

most of the Compact I period. The PSRP in 1997, intended to reduce the wage rate differential but this was never realized.

With the grant aid step-downs of Compact I and continuing grant aid decline built into Compact II, the government cannot be a future source of employment growth. The right to freely immigrate into the US in conjunction with a scarcity of jobs in the domestic economy, has led to a large out-migration of younger workers and their families. With higher pay and job training incentives available in Guam, the CNMI, and in the US, out-migration is likely to be a continuing reality that will have to be taken into account in strategic planning, as discussed in 7.3.

6.2.3.4 Enabling Environment

In addition to assisting the PSEU in the National DEA to work with the states in facilitating PSE transformations, the long-term PSD advisor has been working with the states to implement laws and regulations on key commercial codes that are taken for granted in most countries. These include a bankruptcy law, secured transactions law, revisions to foreign investment laws and regulations, and legislation or regulatory changes to facilitate use of land (owned or leased) to secure mortgage lending.

Another function of government that is critically important but is not addressed by the PSD program is the provision of information and technical assistance to key productive sectors such as agriculture, fisheries and tourism. In agriculture, for example, a well-qualified group of extension agents is based at the national COM campus, but is unable to provide field visitations to farms to assess needs and give technical advice. Also, since the closure of most state agriculture departments, no commodity price, supply, export and import and other important industry statistics are made available to farmers and other sector stakeholders. For the fisheries and visitor sectors, lack of industry data and information is also a problem. Basic sector or industry performance data and technical assistance is an important enabling service that government either provides, or contracts for, to support the sector.