



Pacific Studies Series

Executive Summary

**Federated States of Micronesia
2005 Economic Report**

Toward a Self-Sustainable Economy

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Preface

This is an executive summary of the 2005 Economic Report for the Federated States of Micronesia. The report focuses on the impact of the amended Compact of Free Association or Compact II. The need for major economic reforms is widely recognized in FSM, and the Government prepared a Strategic Development Plan to facilitate the transformation of the economy.

The report was prepared under a technical assistance project provided by the Asian Development Bank (TA No. 4226-FSM): “Preparation of a Country Economic Report.” The lead author of the report was Dr. Robert Lucas, Pacific Economies Expert. Members of the team were: William Nall, Institutions Specialist; Anthony Ryan, Agricultural Economist; Hugh Walton, Fisheries Sector Specialist; John Hagelelgam, Compact Expert; and Augustina Takashy, Institutions Expert and Coordinator.

Abbreviations List

ADB	Asian Development Bank
BNPL	Basic needs poverty line
CNMI	Commonwealth of the Northern Mariana Islands
EEZ	Exclusive Economic Zone
EMPAT	Economic Management and Policy Advisory Team
EPIC	Economic Policy Implementation Council
FPL	food poverty line
FSM	Federated States of Micronesia
GRT	Gross Receipts Tax
HIES	Household Income and Expenditure Study
IDP	Infrastructure development plan
JEMCO	Joint Economic Management Committee
MDG	Millennium Development Goal
MFA	Micronesian Fisheries Authority
MMA	Micronesian Maritime Authority
NGO	nongovernment organization
PSD	Private Sector Development
PSE	Public Sector Enterprise
PSEU	Public Sector Enterprise Unit
PSRP	Public Sector Reform Program
R&D	Research and development
SDF	Social Development Fund
SDP	Strategic Development Plan
SOE	State Owned Enterprise
SPMs	Strategic Planning Matrices
VAT	Value added tax

Introduction

The Federated States of Micronesia is at a critical juncture. The amended Compact of Free Association or Compact II was enforced in 2004 resulting in a more restrictive aid regime. Major economic adjustments are required for the transition to be as unproblematic as possible. The challenge is made greater by the fact that during the nearly twenty years since the beginning of Compact I, the progress of the economy has not measured up to potential and expectations.

The ultimate goal is to put the economy on a sustainable growth path. This means adopting the 'high growth strategy' endorsed in the 3rd Economic Summit. However, attaining this vision will not be a simple matter. Economic reforms must be carried out or continued at all levels of society. Most of these measures are contained in the Strategic Development Plan (SDP) submitted to the FSM Congress for approval in January 2005. Specific objectives include establishing a viable public sector, promoting a dominant and efficient private sector led by tourism, reducing hardship, and achieving a more equitable distribution of income.

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The SDP is at the center of other broad efforts to ensure consistency and sustainability at the macroeconomic level. The Public Sector Reform Program (PSRP), which was implemented to mitigate adverse impacts related to the built-in step-downs in Compact I assistance, has been geared towards rationalizing public sector enterprises, streamlining the bureaucracy, and improving revenue effort. The PSRP was dovetailed with private sector development (PSD) programs, one of which was an ADB project.

Meanwhile, there is concern that the SDP has not integrated the infrastructure development plan (IDP) since the latter was prepared separately. This particular issue can be addressed through the various sectoral plans. The SDP must also be supported by an effective performance budgeting process.

While the SDP provides valuable information and analysis of the current development situation and presents a vision for development in the next 20 years, the question is whether it can be implemented by FSM governments. This apprehension stems from the relative ineffectiveness of the Economic Policy Implementing Council (EPIC) in pushing the reform agenda. It is not only important that the political leadership of FSM governments reach a consensus in approving and supporting the SDP, but that civil society and the private sector also be given the opportunity to participate in the process leading to the SDP approval.

Governments in the FSM have not addressed the hardship issue directly in their strategic planning. However, relevant measures are contained in specific sectors such as human resource development, agriculture, out-migration, and access to land. Proposed reforms can also be related to other millennium development goals (MDGs) and tied to the establishment of a social development fund (SDF).

The reform program should also be sensitive to the customs and traditions of the FSM society, which is fiercely ethnocentric. A case in point is the problem of access to land, where narrowly conceived legalistic approaches to resolving this problem are almost certainly bound to fail.

Box 1. Economic Benefits of Compact II

- Annual grant assistance starts at \$76.0 million in the initial 3-year period 2004-2006. This will steadily decline from 2007 to 2023 as an additional \$0.8 million each year will be taken from the grant portion and deposited in a Trust Fund along with an annual deposit of \$16.0 million by the US. For example, the grant amount in 2010 will be \$72.8 million. All amounts noted here do not reflect the required \$0.2 million amount to be deposited into a Disaster Assistance Fund, and partial adjustment for inflation in the amount of two-thirds the percent change in the US GDP implicit price deflator, or 5%, whichever is less.
- The Trust Fund is intended to replace annual US grant assistance beginning in 2024 following the end of Compact II grant assistance in 2023.

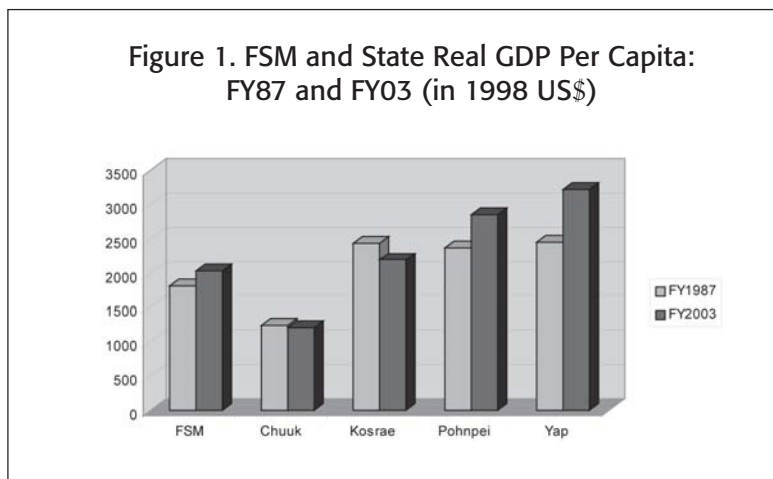
The annual grant will be allocated to six sectors: (1) education, (2) health, (3) private sector development, (4) capacity building in the public sector, (5) environment, and (6) public infrastructure. Allocations will be determined in accordance with sector development plans prepared by the FSM, consistent with annual sector grant proposals made by FSM, and subject to policy review and annual discussions by the Joint Economic Management Committee (JEMCO). Voting membership of JEMCO includes three members from US and two members from FSM. Policy decisions will be in accordance with majority vote.

- Additional grant and program assistance is made available under Section 221 (of Title Two – Economic Relations). Stipulated programs (received in the form of services) include those received under Compact I such as US Weather Service and Postal Service, and grant assistance to education and health sectors under the Supplemental Education Grant (SEG). In the fiscal year 2005, the amount of the SEG grant was \$12.2 million. The SEG amount is not set and will vary from year to year. Additional US federal grant assistance is available on a competitive basis with other US states and territories. Available funding is ultimately dependent on US Congressional appropriations.

Economic Performance

Considering the entire 17-year Compact I period, the performance of the FSM economy with respect to GDP and employment has been relatively poor. As shown in Figure 1, for the FSM as a whole, real GDP per person at the beginning of Compact I was \$1,822 and over the entire Compact I period increased to only \$2,031, averaging a mere 0.7% growth per annum. Among the four States, Yap performed best, increasing its real GDP per capita by 32.5% with growth averaging 1.8% per annum. Kosrae actually suffered a decline in per capita real GDP as did Chuuk from its already low per capita GDP of \$1,249 at the beginning of Compact I. Pohnpei, however, was able to increase its per capita real GDP by nearly 20%, with growth averaging just over 1%.

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Reflecting the top-heavy public sector, government accounted for an average of 58.7% of employment for the period 1987-89 (Table 1), compared with a 31.6% employment share for the private sector, 7.9% for the non-profit sector, and 1.9% for public sector enterprises (PSEs). In terms of GDP contribution, government accounted for a 37.5% share, compared with 26.8% for the private sector. Both PSEs and the non-profit sector contributed 2.9% of GDP.

At the end of Compact I, based on the 3-year average for 2001-03, the private sector accounted for 42.6% of total employment reflecting an 11 percentage point gain. In terms of GDP contribution, the rise in the private sector share was significantly less—only a 4 percentage point gain—than the employment share. The reverse was true for the government where the decline in share of GDP of 10.3 percentage points was less than the drop in employment share. This indicates that productivity gains in the private sector were quite limited. The significantly smaller gain in GDP contribution of the private sector over the 17-year Compact period, compared with employment, can also be explained by the persistently large gap in wage rates between government and private sectors.

Table 1
FSM Employment and GDP by Institutional Sector: 1987-89 and 2001-03
 (%)

Sector	1987-1989 Average		2001-2003 Average	
	Employment	GDP	Employment	GDP
Private	31.6	26.8	42.6	30.8
Government	58.7	37.5	42.9	27.2
Public Sector Enterprises	1.9	2.9	5.6	7.6
Non-Profit sector	7.9	2.9	8.9	4.8
Other ^v	–	29.9		29.6
Total	100.0	100.0	100.0	100.0

^v Other GDP includes subsistence, home ownership, indirect taxes, less bank charges.

Macroeconomic Issues

Facing a significant reduction in grant funding, and an aid management regime under Compact II that stipulates the allocation of funding among relatively few priority sectors, FSM governments will have to reach a consensus on new economic development policies and strategies. A conducive macroeconomic environment is important in promoting investment, economic growth, and overall stability in society. In turn, economic growth is a necessary condition for alleviating hardship.

Obtaining the political consensus that assures wide ownership and support of the SDP is critical for successful implementation....

National Strategic Development Plan

National strategic development planning in the past decade has been linked to the economic summits. The principal motivation for convening the 1st Summit was the design and implementation of a PSRP to accommodate the sharp step-down in Compact I funding in 1997. The 2nd Summit was more concerned with consolidating improvements in fiscal performance and in formulating more effective development strategies for the future. The 3rd Summit was primarily focused on integrating strategic planning with performance budgeting, and was structured to meet Compact II requirements for submitting sector plans and for implementing monitoring.

It is critically important that the FSM have resident (citizen) capacity to carry out strategic planning on a continuing basis at both national and state levels. This institutional effort should be initiated in-step with the National Government's planned establishment of an office that will carry out the planning, reporting, and coordinating of budget preparation, as required by JEMCO.

This proposed office must coordinate with state level counterparts; and given that plan implementation and monitoring will be of utmost concern to policy makers (and also for Compact II reporting), there will be a need for explicit linkages with the budgeting process at both national and state levels.

Obtaining the political consensus that assures wide ownership and support of the SDP is critical for successful implementation, and therefore there needs to be renewed effort to obtain commitment on the part of the political leadership to authorize and follow the recommendations and decision-making of EPIC (or a similar body).

Commitment to Private Sector Development

More than ever, there is a need to achieve increased growth in private sector activity to create new jobs and to provide an expanded tax base to enable an increase in revenue effort. A number of factors contributing to this enabling environment must be addressed, including strengthened communications between the public and private sectors, rationalization of the PSE sector to remove unfair competition, proactive initiatives to contract out activities that can be more efficiently performed by private businesses, a needs assessment to pinpoint and address industry short- and longer-term skills training to raise productivity, a regulatory climate characterized by transparency and efficient customer-oriented responsiveness of public agency services, and a legal framework supportive of business that includes secured transactions and bankruptcy laws. To overcome the lack of private sector confidence and credibility generated by failed past commitments, governments must immediately establish mechanisms to foster dialogue and the formation of joint public-private working groups that are empowered to accomplish specific objectives.

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Boosting Fiscal Performance

There is a need to increase tax revenues to offset declining Compact II resources and to provide budgetary balance that leads to better macroeconomic performance, which is necessary to promote private sector growth and investment. As recommended by several technical assistance missions, the FSM may consider implementing a value-added tax (VAT) to replace import and state sales taxes. Even if introduced on a revenue neutral basis, the VAT would still be advantageous because it eliminates the distortionary effects of the sales and import taxes. Enforcing a single rate, the VAT will avoid the cascading effect as goods and services move through the different levels of distribution. Moreover, the VAT is relatively simple to administer and would apply to a broad tax base including both goods and services and private and public enterprises.

...the FSM may consider implementing a value-added tax (VAT) to replace import and state sales taxes....

Given the complex tax structure of the FSM, with the different constitutionally mandated taxation powers, the recommended approach for administering the VAT and all other taxes would be a single FSM unified tax

administration. Although considerable effort and coordination would be required to implement this, there would be clear benefits through increased efficiency and better enforcement.

Strengthening Public Sector Capacity and other Human Resource Development Initiatives

Strengthening institutional capacity, particularly in economic and financial planning and management, is a high priority in all governments. Integrating strategic planning and performance budgeting will require substantially more training to enable efficient and effective execution of the monitoring, reporting, budgeting, strategic development planning and creating grant proposals needed to satisfy Compact II requirements. Other HRD elements would include more rigorous application of job position skill and education requirements, elimination (or contracting out) of non-essential government functions, and implementation of measures to achieve comparable pay rates for equivalent jobs in public and private sectors (and equivalence across governmental levels—state and national).

In the future, there needs to be greater attention directed to ensuring that indigenous personnel are educated and trained to fill high-level professional and technical positions in policy, planning, finance and statistics. Measures (incentives) need to be implemented to enable governments to retain such expertise so that the heavy dependency on external know-how experienced in the past can be significantly reduced.

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HRD must also be a major priority in the private sector. The FSM governments need to petition JEMCO for an adjustment in Compact policy so that greater priority will be placed in funding the private sector development grant. Private sector development policy should also enable FSM governments to utilize augmented PSD grant funding to design and pay for skill training, institutional and technical support to small businesses, and—with proper safeguards specifically built into project or program designs—funding for credit facilities in support of small businesses.

One of the foremost constraints to private sector development is the lack of occupational and entrepreneurial skills. Although Compact II gives priority to education, most of the allocated funds are used for mainstream

education programs, with very little available to provide vocational and technical training. To attract increased domestic and foreign investment, it is important that there be a ready availability of technical training. Companies will be needing this not only so they may hire skilled workers, but so that there will be the opportunity to train their workers. This is related to the aforementioned recommendation that the Compact II policy be adjusted to allow funds for skill training.

Improving Governance

As frequently noted, commitment (to stated policies), transparency, accountability, efficiency, equity (fairness), participatory action, and predictability are important attributes defining governance. Strengthening inter-governmental cooperation in adopting and managing consistent and efficient economic policies, effective joint administrative and enforcement operations, and timely resolution of jurisdictional issues, must be given high priority.

Determining an appropriate approach to improving governance poses a major challenge. Community and political leaders should consider asking a reputable international organization (several regional bodies might be appropriate candidates) to assist a specially-formed commission to draft a governance policy and associated action plan for implementing measures (e.g., laws, regulations, oversight agencies, changes in existing laws and regulations) to strengthen governance in the FSM.

JEMCO Support

The current policy of JEMCO is to phase out the public sector capacity building grant and effectively minimize funding for PSD through restrictions on eligible uses of sector grant funding. On behalf of all governments, the FSM-JEMCO delegation needs to petition US-JEMCO counterparts for policy adjustments to reverse such policies. The project approach could be used to pay for technical assistance aimed at facilitating the transformation of PSEs (i.e., commercializing privatization and contracting out public sector commercial activities). If the FSM shows a firm commitment to achieving capacity-productivity enhancing goals and can present specific project designs, it is quite reasonable to expect a favorable response on the part of the US-JEMCO delegation.

Attracting Foreign Investment

There must be renewed commitment on the part of national and state governments to attract foreign direct investment (FDI) particularly in fisheries and tourism. Important elements in promoting greater foreign and domestic investment include: (a) greatly improved public-private sector dialogue (as noted earlier); (b) reasonably predictable costs of doing business; and perhaps most importantly, (c) transparency of foreign investment regulations. National and state governments need to reach a consensus on a consistent, transparent set of procedures for issuing foreign investment permits. As pointed out by the World Bank's Foreign Investment Advisory Service (FIAS) in its 1999 review of FSM laws and regulations, the intent of the foreign investment law should be to make the issuance of a foreign investment permit a simple registration process. That is, regulations should be sufficiently transparent to enable an interested investor to know whether they will qualify for a permit before they apply. Each State could decide on its own list of industries or activities that would be closed to foreign investment ('red' list), but for the so called 'amber' list (those industries/activities requiring investors to meet specified conditions), transparent regulations would clearly indicate what conditions must be met, i.e., there would be no need for a case-by-case review of an investor's application.

National and state governments need to reach a consensus on a consistent, transparent set of procedures for issuing foreign investment permits.

Box 2. Good Governance Defined

The term 'governance' means different things in different contexts and to different people. For its purposes, ADB defines governance as ***“the manner in which power is exercised in the management of a country's economic and social resources for development.”*** Governance is concerned directly with the management of the development process, involving both the public and private sectors. In broad terms, governance is about the institutional environment in which citizens interact among themselves and with government agencies. It encompasses the functioning and capability of the public sector, as well as the rules and institutions that create the framework for the conduct of both public and private business, including accountability for economic and financial performance, and regulatory frameworks relating to companies and partnerships.

Source: Mellor, Governance in the Pacific: Focus for Action 2005-2009, 2004, p. 3.

Sectoral Issues

Emerging sectoral economic issues include poor performance of the agriculture, fisheries and tourism sectors, out-migration, and access to land. These issues are emerging as the FSM transitions to the far more restrictive aid regime of Compact II.

Agriculture

The vision for the agricultural sector has been inconsistent, as policy makers have too often looked for the quick fix or magic bullet solutions. Government-support programs, while intended to serve farmer needs, have been rendered ineffective as staff salaries absorb over 90% of the budget leaving no resources for funding services. The problems in agriculture are directly attributable to leadership and governance failures.

In the FSM, a majority of the labor force is active in subsistence farming for home consumption and the marketing of the surplus. However, government policies and programs have been predominantly designed to support commercial agriculture. Current policies have failed to adequately account for subsistence and semi-subsistence farming systems and their inherent characteristics.

The 2000 Census showed increasing reliance on subsistence agriculture—indicating a declining capacity to buy imported food—and a threefold increase in the number of women engaged in subsistence agriculture. About 17% of the working age population depended primarily on subsistence agriculture and fisheries in 2000, almost double the percentage in 1994. Rice has become the main food staple in the FSM with imports in 2002 worth almost \$6.0 million. The shift away from reliance on traditional crops has brought cash shortages and shipping delays. Chuuk State, with half the country's population and 12% of its arable soil, is considerably more vulnerable to food shortages. Food security in the outer islands is underpinned by swamp taro and copra sales.

The approach to developing commercial agriculture that is most likely to succeed is in accessing several small, diverse niche markets for different crops, recognizing that some markets will close, but others will become available. In terms of the local market, there is modest room for import substitution, as about \$1.4 million out of the \$28.2 million of the 2002 food imports could be produced locally. Given this market situation, government's

role is to provide an enabling environment: a consistent and appropriate policy framework, secure land tenure, public infrastructure, R&D, up-to-date market information—including prices, marketing costs, and customer feedback—and effective quarantine and protection services. The private sector’s role is to find and fill markets with quality products on a consistent basis.

... government’s role (in agriculture) is to provide an enabling environment: a consistent and appropriate policy framework, secure land tenure, public infrastructure....

The farmer’s role is to provide products that meet the quality and quantity requirements of the market on a regular basis. The roles of farm producers, marketers and government cannot be effectively carried out without regular dialogue among all three sectors. Such dialogue does not occur in FSM at this time.

Fisheries

With over 600 islands and atolls, and a one-million-square-mile Exclusive Economic Zone (EEZ), marine resources are FSM’s largest resource. Resources may be classified into three categories: near-shore and coastal, aquaculture, and oceanic. The value of near-shore and coastal fisheries has been estimated at around \$24.5 million, half subsistence and half commercial. As for aquaculture, very little commercial development has occurred, although black pearl culture shows some promise. Oceanic resources, mainly offshore tuna fishery, are the primary source of revenue and hold the largest potential for longer-term development. Other productive components of the oceanic resources sector include infrastructure and long-line tuna transshipment and purse seine transshipments.

The most significant problem with oceanic fisheries in the FSM is the failure to fully realize the potential benefits associated with the exploitation of available resources. While the FSM has enjoyed a reasonably consistent return from fisheries access fees, attempts to promote returns through infrastructure investment, transshipment, domestic fishing, value-added processing, vessel servicing, and employment have essentially failed.

A number of significant development constraints have been identified, including:

- Limited FSM labor pool in both size of workforce and range of skills. The tuna industry needs foreign expertise and management until Micronesians can be trained and can gain experience in the industry.

- All non-service FSM State and National government enterprises that have been in operation for more than 2 years have proven unprofitable.
- For longline transshipment, the inability to extend airport runways in almost every state could constrain development. Additional runway length allowing larger aircraft and improved payloads could be a key factor in achieving airfreight economies of scale.
- Though simple to administer and understand, the Gross Receipts Tax (GRT) is a “cascading” tax and the prevailing tax regime is a disincentive to primary industry and manufacturing investment.
- A very significant problem in the FSM is the difficulty in finding out exactly what the current law is.

While strategies to mitigate these constraints have been reflected in policy documents, there has been limited success in addressing these concerns. It is generally agreed that the principal issue is limited accountability in policy implementation and a lack of political will. This is especially apparent at the State level in relation to dealing with difficult issues such as the commercialization of State-owned assets.

An additional issue relates to communication and the need to clearly define responsibilities in relation to policy implementation. The formation of the FSM Offshore Fisheries Association in 2002 has provided a clear direction for an industry voice in policy determination and implementation. However, in the case of government, there is a range of conflicting national and state agencies with varying responsibilities for policy making. For a potential foreign investor in fisheries, there is no clear process or specific agency to facilitate the investment process.

It is clear that further development of the sector cannot take place without additional investment. Governments in the FSM have invested large sums in fisheries projects with poor results. The domestic private sector has been similarly affected by poor sectoral performance. Investor confidence will continue to be constrained by an ongoing failure to address development issues and achieve progress with policy implementation.

The formation of the FSM Offshore Fisheries Association in 2002 has provided a clear direction for an industry voice in policy determination and implementation.

Tourism

Tourism in the FSM has long been recognized as a sector with strong growth potential. The Third Economic Summit took an unprecedented step in designating tourism to be the dominant sector enabling envisioned growth and development of the economy in the 2004-2023 Compact II period. This policy stance represents a major change in thinking on the role of tourism in development.

International visitor arrivals in the FSM numbered about 18,000 in the fiscal year (FY) 2004, down from 20,000 visitors in FY2000, which was the peak of international visitor arrivals since FY1996. In comparison with growth rates of tourism arrivals in the Pacific Islands region, which recorded an increase of 23 % in the 1996-2003 period, the FSM has clearly under-performed. Based on an FSM total hotel room inventory of 476 rooms capable of accommodating international visitors, 42,000 tourists would be required annually to achieve the occupancy rate of 65% considered necessary for profitability in the industry. It is clear that if the FSM is to look to tourism as the dominant or leading sector for the nation to achieve sustainable growth and development, the industry will have to expand dramatically from current levels of activity.

...the goal for tourism development in general should be to develop "high-end, low-impact" tourism, meaning relatively modest numbers of visitors, each making a relatively large financial impact....

Table 2
International Visitor Arrivals to the FSM by Nationality

Nationality	1996	2000	2001	2002	2003	2004
Asia	2,029	2,890	2,255	2,680	2,877	3,152
Europe	1,007	1,427	1,235	1,343	1,668	1,353
Japan	5,519	4,661	3,194	4,061	3,984	3,661
Pacific Islands ^V	2,282	2,151	1,589	2,150	1,932	2,425
USA	7,083	8,605	6,966	8,152	7,736	7,101
Other	239	304	255	314	299	312
Total	18,159	20,038	15,494	18,700	18,496	18,004

^V Includes Australia and New Zealand visitors.

In view of the constraints to tourism development in the FSM as a small developing nation with strong traditional values and lifestyles, the goal for tourism development in general should be to develop "high-end, low-

impact” tourism, meaning relatively modest numbers of visitors, each making a relatively large financial impact in terms of average daily expenditure. Residents in each state have expressed concern about tourism causing damage to the social and cultural dynamic, and also to the fragile natural environment. While there will be an inevitable impact, policy makers will need to strike a careful balance between sector development and sustainability.

At present the nation offers a very limited range of activities and opportunities for visitors, and therefore product development is a critical area that the tourism industry will have to address. Even the most rudimentary amenities expected by international visitors are not available, such as sidewalks or boardwalks, trails, access to beaches or shoreline areas, and public transport such as buses and safe boat services.

Infrastructure is poor both in terms of overall services such as power, safe water and healthcare, and in terms of the tourism sector itself. For example, some hotels do not meet international standards, immigration/emigration procedures are poor and unwelcoming, and airport facilities are deficient. Given the relatively low volumes of passenger traffic handled by the four main airports, the time required to pass through the airport and board departing flights is grossly excessive.

The FSM appears to be caught in a “Catch-22” situation in which tourism under-performs because of a lack of infrastructure, poor service and promotion, which in turn results in low profitability and little public and private investment. Consequent low visitor satisfaction, in turn, leads to unfavorable word-of-mouth recommendations, thus perpetuating the sector’s under-performance.

Another significant constraint to tourism development is the lack of unanimous commitment to tourism in all States. There is a need to educate the general public on the importance of tourism; and with respect to the political leadership, there needs to be full commitment.

In summary, with a strong commitment of all five FSM governments to policy reform and full support (including support of the general public), tourism could contribute substantially to the FSM ultimately achieving sustainable growth and increased self-sufficiency. However, the SDP is not clear on the growth targets for the tourism sector, or how sufficient resources are to be mobilized to fund the very large implied cost of comprehensively (and simultaneously) implementing the activities and outputs that will be necessary to achieve the sustained and substantial tourism growth envisioned in the SDP.

Out-Migration

Out-migration has significantly increased since 1997. Whether viewed as a negative or longer-term positive for economic development, the FSM will have to pay more attention to out-migration, both in terms of its extent and likely consequences. Certainly more information and analysis will be needed to formulate policy options. What is apparent is that if the FSM economy continues to perform poorly in terms of job creation and providing adequate household incomes, there will likely be continued heavy out-migration of FSM citizens.

From the US Census Bureau surveys done in the Commonwealth of the Northern Mariana Islands (CNMI), Guam and Hawaii in 2003, it is evident that FSM emigrants are younger, better educated and have emigrated mainly to seek jobs. However there is no socioeconomic data on emigrants to the US Mainland, and even in terms of number of citizens only approximates are given. Anecdotal information indicates that many, if not a majority, of the emigrants to the US leave to earn a 4-year college degree. Another significant group of emigrants are those that join the US armed services.

As large numbers of younger residents out-migrate, population growth will decline and the demographic profile (age distribution) will change. Without better data on the rate and characteristics of out-migration, together with appropriate demographic studies, it is difficult to predict likely impacts. One possibility would be an increase in the dependency ratio (i.e., ratio of number of nonworking age to number of working age population), whereby there are fewer workers to support those that cannot work, with consequent household hardships. Given that lack of jobs and income tend to be more prevalent in rural and out-island areas, there may be much greater out-migration from these places, with consequent disruption in the delivery of social services as facilities must be closed because of cost factors.

One likely impact (of out-migration) would be an increase in the dependency ratio, whereby there are fewer workers to support those that cannot work... On the positive side, greater out-migration... could...become a major source of remittance income.

On the positive side, greater out-migration in the long-run could result in significant benefits, if citizens living in the US and other countries become a major source of remittance income. In many South Pacific nations such as Tonga and Samoa, overseas remittances are a major source of foreign exchange and household income. Another potential longer-term benefit

would be the return of citizens who have lived abroad that have acquired occupational and entrepreneurial skills needed in the FSM economy.

Box 3. Socioeconomic Differences Between FSM Residents and Out-migrants in US¹

- In the 20-39 age group, there is a significantly larger percentage of both males and females (39.1% and 38.4%, respectively) in the out-migrant population, compared with the FSM resident population (27.1% and 28.3%, respectively).
- With respect to educational attainment of persons over the age of 25, 53.6% of migrants had a high school diploma or at least some level of high school attainment, compared with 32.3% of FSM residents. Among migrants, 18.8% attained an AA or AS college degree or some college with 14.8% of FSM residents who have similar education levels. More FSM residents did have a bachelor's or a higher degree – 3.6% compared with 1.8% of migrants. The latter figures for higher educational achievement are not surprising, given that the majority of FSM citizens seeking a bachelors or higher degree probably go to a mainland US institution. But data for the US mainland migrants are not available.
- In terms of income, median household income in 2002 for out-migrants was \$21,317, compared with the 1999 household median income of \$4,618 for FSM residents. For individuals 25 years old and over, the median income of out-migrant population in 2002 was \$11,041 for males and \$8,928 for females. For FSM residents, the median income for males age 25 and over was \$2,044 in 1999, and for females it was \$918.
- In terms of reason for out-migration, of those born outside the impact area, the main reason given was employment (33.2% of all persons surveyed). The second most common reason was that the migrant was a dependent of employed person (23.9%). None of the other reasons given accounted for more than a 6.8% share of the reasons, but a large number surveyed gave no reason (25.7%).

¹ Characteristics are for those migrants in CNMI, Guam and Hawaii only, based on the 2003 surveys, compared with FSM residents surveyed in 2000 Census. Data are not available for FSM citizens living in US Mainland.

Improving Access to Land

Improved access to land would contribute substantially to a more favorable business climate, particularly with respect to both domestic and foreign investment. However, given the high intrinsic sociocultural value of land in all the communities comprising the FSM, significantly improving access will be a major challenge. Nevertheless, with increased monetization of the economy over time, and the recent large rise in subsistence production, there has been more interest in buying and selling land. From a

social welfare perspective, increased motivation to sell land may not be viewed as a favorable indicator. However, from an economic standpoint, it is clear that land is a critical factor of production and thus improving access would likely promote increased business activity and creation of new jobs.

While the states have jurisdiction over laws and regulations covering land ownership and transactions, uniformity of various aspects of land-related laws and regulations are important in efficiently and effectively conducting interstate commerce, and therefore national government must also play a role in improving access to land. National and State governments need to vigorously pursue the land use and land tenure reforms that have been initiated under the current PSD program. Land registration and surveys in the FSM still cover only a fraction of all land holdings, and in some jurisdictions courts have large backlogs of contested ownership and other legal cases.

In view of both the sociocultural sensitivity towards land and the importance of access to land for business development, it would be very useful for the five FSM governments to hold an international conference on land tenure and management practices that have been successful in promoting economic development.

In view of both the sociocultural sensitivity towards land and the importance of access to land for business development, it would be very useful for the five FSM governments to hold an international conference on land tenure and management practices that have been successful in promoting economic development. Other countries in the Pacific region have confronted the land issue with success, and their experience might prove to be insightful to the FSM. The conference should be held in conjunction with the formation of a committee or taskforce with representation from all states to review progress in making land more accessible for all FSM citizens and for both domestic and foreign businesses. The committee should also assess potential means for government to compile and disseminate land transaction data, to enable a more efficient market in land transactions.

Addressing Hardship

Significant hardship exists in the FSM, particularly in outer island and rural communities. Similar to other Pacific island nations, poverty in the FSM is generally not defined as people suffering starvation or destitution, but rather put in the context of hardship. The latter is a situation in which people lack access to basic services or lack opportunities or adequate resources (including cash) to meet the basic needs of the household or customary obligations to the extended family, village community or the church.

An analysis of the 1998 Household Income and Expenditure survey and 2000 Census data showed that there was a large incidence of low income families who experienced periodic cash shortages that kept them from meeting all their basic needs. The hardship assessment defined food ‘poverty’ lines (FPL) and basic needs ‘poverty’ lines (BNPL) in relation to the cost of providing a low-cost, basic nutrition diet in each State. Based on the FPL and BNPL criteria, a surprisingly large proportion of households in the States had incomes below the BNPL. In the FSM, 27.9% of households were below the BNPL. By state, 32.9% of Chuuk households, 12.3% of Kosrae, 29.5% of Pohnpei, and 14.4% of Yap households fell below the BNPL.

The survey also indicated substantial inequality in the distribution of income, whether measured in terms of household income or expenditure, particularly for Chuuk and Pohnpei States, which account for over 80% of total national population. Distribution of household income and expenditures in the top and bottom quintiles and by State is shown in Table 3.

Table 3. Distribution of Income and Expenditure: 1998
(%)

State	Bottom Quintile		Top Quintile	
	Income	Expenditure	Income	Expenditure
Chuuk	6.2	4.1	35.4	56.8
Kosrae	5.3	9.3	49.1	36.4
Pohnpei	4.3	5.5	52.1	49.3
Yap4.1	5.5	51.6	46.0	
FSM	3.6	4.5	55.5	52.6

NOTE: Bottom and top quintiles refer to 20% of households having the lowest income (expenditure) and highest income (expenditure), respectively, when all households are ranked from highest to lowest with respect to amount of income (expenditure).

Millennium Development Goals (MDGs) have been formulated for the developing countries in the Pacific region, including the FSM. The MDGs include measures or indicators related to education, health, environmental sustainability, and gender equality, in addition to those that have to do with hardship. Definitive quantitative targets to be achieved by 2015 have been set to meet specific goals. For example, for the goal of reducing infant mortality, the target is to reduce the rate by two-thirds by 2015. The current infant mortality rate (per 1000 live births) in the FSM is 40, so by 2015 the rate in the FSM should be under 14. The goals for hardship defined in the FSM in accordance with the FPL and BNPL criteria, call for halving hardship by 2015.

...the potential could be tapped by FSM governments working more directly with NGOs, particularly if this partnership is facilitated by dedicated funding and an agency or bureau responsible for coordinating all these efforts....

The NGO sector represents large unrealized potential towards enabling the nation to achieve sustainable development and increased self-sufficiency. While the NGO sector is heavily involved in social and economic development, the potential could be tapped by FSM governments working more directly with NGOs, particularly if this partnership is facilitated by dedicated funding and an agency or bureau responsible for coordinating all these efforts. While there is currently little or no domestic revenues or Compact funds available to operate either an agency or finance a social development fund, there are good prospects for attracting donor community funding for the proposed SDF and administering agency (Community Development Agency/Bureau). The proposed agency and SDF can work directly with the NGO sector by contracting individual or consortiums of NGOs to provide community services such as adult education, technical assistance to community based businesses, public education and awareness (e.g., tourism industry community education and public awareness, adult literacy).