



Technical Assistance Report

Project Number: 41056
August 2007

Federated States of Micronesia: Strengthening Economic Management and Planning (Financed by the Japan Special Fund)

Asian Development Bank

CURRENCY EQUIVALENTS

The currency of the Federated States of Micronesia is the United States dollar.

ABBREVIATIONS

ADB	–	Asian Development Bank
DEA	–	Department of Economic Affairs
DFA	–	Department of Finance and Administration
FSM	–	Federated States of Micronesia
FY	–	fiscal year
GDP	–	gross domestic product
IMF	–	International Monetary Fund
JEMCO	–	US-FSM Joint Economic Management Committee
JSF	–	Japan Special Fund
SDP	–	Strategic Development Plan 2004–2023
TA	–	technical assistance
US	–	United States
US GAO	–	United States Government Accountability Office

TECHNICAL ASSISTANCE CLASSIFICATION

Targeting Classification	–	General intervention
Sector	–	Law, economic management, and public policy
Subsector	–	National government administration
Themes	–	Governance, private sector development, capacity development
Subthemes	–	Financial and economic governance, policy/institutional/legal/ regulatory reforms, institutional development

NOTES

- (i) The fiscal year (FY) of the Government and its agencies ends on 30 September.
- (ii) In this report, “\$” refers to US dollars.

Vice President	C. Lawrence Greenwood, Jr., Operations Group 2
Director General	P. Erquiaga, Pacific Department (PARD)
Director	I. Bhushan, Pacific Operations Division (Area B), PARD
Team leader	E. Ferguson, Economist, PARD

I. INTRODUCTION

1. The Government of the Federated States of Micronesia (FSM) requested the Asian Development Bank (ADB) to provide technical assistance (TA) to support national and state governments in strengthening their execution of performance-based budgeting to facilitate implementation of priority actions identified in the Strategic Development Plan 2004–2023 (SDP). The need to improve budget management and plan implementation within the broader context of improved economic management has been recognized domestically¹ as well as in external assessments of the FSM by ADB, International Monetary Fund (IMF), and United States Government Accountability Office (US GAO).²

2. The TA Fact-Finding Mission visited the FSM during 18 April–3 May 2007 to assess the relevance and scope of this TA.³ Discussions were held with representatives of the national Government and three state governments and other stakeholders. An understanding was reached on the TA impact, outcome, outputs, implementation arrangements, cost, financing arrangements, and terms of reference for consulting services. The TA design and monitoring framework is in Appendix 1.

II. ISSUES

3. The FSM has received high levels of external assistance since independence in 1986, predominantly from the US under the Compact of Free Association. Yet the economy remains heavily dependent on the public sector (overall public expenditure is equivalent to around 60% of gross domestic product [GDP]), with limited private sector activity and a narrow export base. On a per capita basis, GDP was estimated at \$1,952 in fiscal year (FY) 2006. Growth averaged only 1.3% between 1987 and 2003 (the period of the first Compact), the economy contracted by an estimated 0.7% in 2006, and growth of just 1.0–1.5%⁴ is expected in 2007 and 2008. Aid flows, in combination with a lack of capacity, have contributed to some poor habits going unchecked—limited financial responsibility, limited monitoring of performance, reliance on the public sector, substitution of aid for raising domestic revenues, and limited demand for policy change.

4. External assessments of the FSM by ADB, IMF, and US GAO have all identified unsustainable fiscal management and failure to implement key development priorities as major impediments to achieving self-sustaining economic growth. The need to improve budget management and strategic plan implementation within the broader context of improved economic management has also been recognized domestically, most recently in national Government assessments of Chuuk and Kosrae states and also in the FSM report to the Consultative Group Meeting (November 2006).⁵

5. There are increasing pressures to redress the situation. The amended Compact (which came into effect in FY2004) goes some way to addressing issues of financial responsibility and

¹ FSM report to the Consultative Group Meeting, November 2006.

² ADB. 2006. *Federated States of Micronesia 2005 Economic Report*. Manila; US GAO. 2006. *Compacts of Free Association Development Prospects Remain Limited for Micronesia and Marshall Islands*. Report to Congressional Committees, GAO-06-590.

³ The TA first appeared in *ADB Business Opportunities* on 25 April 2007.

⁴ ADB. 2007. *Asian Development Outlook 2007*. Manila.

⁵ This reported that “Recent fiscal deficits have led to a substantial drawdown in reserves so that only Yap has a reasonable level of unrestricted financial reserves. In Chuuk, there are no reserves and government arrears have climbed to over 40% of GDP. There are also no reserves in Kosrae and Pohnpei and the National Government’s reserves are less than 2% of GDP.”

performance monitoring by requiring quarterly financial and performance reports as well as providing the US with the ability to withhold or suspend funds. The FSM is feeling this pressure as the US has now withheld funds every year since FY2004. Furthermore, the amended Compact itself creates substantial fiscal adjustment challenges by placing pressure on recurrent operations expenditures that in the past the Compact funded, but that in the future must be either cut or funded from local revenues. In the longer term, the lack of full indexation of the annual Compact sector grants and the annual decrement of \$800,000 (which is directed to the Trust Fund) will require continuous fiscal adjustment. Finally, the 2023 scheduled end to Compact funding is directing greater attention to the issue of self-sufficiency.

6. The Government recognized these issues prior to the implementation of Compact II and in preparation developed the SDP with the support of ADB.⁶ The SDP was designed to identify priority activities essential to generate the growth required to meet the national goal of self-sustainability by 2023. The broad policy priorities were recognized as, and remain, fiscal adjustment through expenditure cuts and tax reforms, and structural reforms to support private sector development.

7. However, progress in implementing the SDP has been very slow. Responsibilities for planning, monitoring, and coordination are divided among several central agencies and coordination is not effective. At the state level, the varying degrees of knowledge and ownership of the SDP suggest a need to identify a small number of priority actions that can be achieved in the short term and can be regularly revisited and updated, thus creating a stepping-stone path to reaching SDP goals. There have been initial efforts at integrating strategic priorities into budget processes, which is essential to ensure the funding of priority activities, but full integration and performance reporting need further work. Slow SDP implementation has been partly due to capacity limitations and the loose federation of government that has made it difficult to forge a consensus for reform and to coordinate policies.

8. Progress in implementing tax reforms, led by the Department of Finance and Administration's taxation reform project manager, signals strengthened willingness to tackle difficult economic management issues. When fully implemented, the proposed reforms will impact on budget positions and the ability of the FSM to implement the SDP. Yet tax reform alone will not be sufficient to manage fiscal pressures. Attention also needs to be paid to ensuring the efficiency and effectiveness of budget expenditure, particularly in the period before FY2009 when the tax reform will be fully implemented. While a 22% decrease in public sector employment and a 28% decline in the wage bill for government were achieved as part of the ADB-supported Public Sector Reform Project,⁷ since then government employment and expenditure have crept back to levels equivalent to, or above, prereform levels. This assistance thus complements taxation reform and should be coordinated closely with taxation reform.

9. At least two states are currently facing financial difficulties. National Government assessments of the states of Chuuk and Kosrae have found a range of problems in the areas of revenue collection, expenditure management, and procurement, which have resulted in high levels of debt and ongoing and unsustainable budget deficits. In March 2007, Congress appropriated over \$1.4 million for Kosrae to meet immediate needs.

⁶ ADB. 2003. *Technical Assistance to the Federated States of Micronesia for National Strategic Development Plan*. Manila (TA 4171).

⁷ ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Federated States of Micronesia for the Public Sector Reform Program*. Manila (Loan 1529-FSM [SF]). The Project began to be implemented in 1997 and was closed in 1999.

10. This TA is strategically important in that it clearly supports the FSM *Country Strategy and Program Update 2006–2007* key priority of good governance (which includes promotion of effective development processes and support for long-term capacity-building efforts). Importantly, it links two areas where ADB has previously provided support—planning and financial management⁸—to facilitate FSM use of performance information in the budget for results-based decision making and strategic development planning. This TA directly addresses the problematic issues of governance and capacity in financing and implementing the SDP by developing long-run adjustment/sustainable transition plans, strengthening capacity in performance budgeting, and interlinking the budgeting and planning processes. The TA complements ongoing US federal assistance initially targeted at developing performance indicators for the six Compact sectors for the FY2008 budget and reporting on them. Importantly, this TA supports FSM’s capacity to utilize performance information for sound decision making through developing an awareness and understanding of performance budgeting within the National Congress and state legislatures as well as within departments. Activities will take place within a broader framework of implementing priority development needs to move toward a position of sustainable economic development in the long term.

11. This TA builds on lessons of earlier assistance to the FSM in related areas—in particular, that adequate time needs to be allowed to build the capacity to ensure sustainability of activities. Completion reports for the initial TAs in budget management considered the TAs to have provided a sound basis for budgeting in the FSM, although the TAs had not created integration into planning processes nor generated a high level of political interest in strengthened budgeting, which would lift the use of performance budgeting to the next level. These are of particular focus in this TA.

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

12. The impact of the TA will be to support the implementation of the SDP and its goal of economic self-sufficiency. The TA seeks to achieve the outcome of interlinked budget and planning processes supporting sustainable economic development.

B. Methodology and Key Activities

13. The TA will support assistance in the interrelated areas of public financial management and national planning and will build on and complement earlier and ongoing related assistance. To support the achievement of the impact and outcome described above, the TA will be in two

⁸ ADB provided broad support for economic policy reform through ADB. 2001. *Technical Assistance to the Federated States of Micronesia for the Economic Policy Reform and Capacity Building Phase I*. Manila (TA 3783); ADB. 1998. *Technical Assistance to the Federated States of Micronesia for the Economic Policy Reform and Management*. Manila (TA 3024); ADB. 1997. *Technical Assistance to the Federated States of Micronesia for the Expansion of the Economic Management Policy Advisory Team*. Manila (TA 2294); and ADB. 1995. *Technical Assistance to the Federated States of Micronesia for Policy Advisory Team for Economic Management*. Manila (TA 2294). The TAs supporting improved financial management were ADB. 2003. *Technical Assistance to the Federated States of Micronesia for the Strengthening of Public Sector Management and Administration*. Manila (TA 4258); ADB. 2001. *Technical Assistance to the Federated States of Micronesia for the Implementation of Performance-Based Budget Management*. Manila (TA 3765); ADB. 2000. *Technical Assistance to the Federated States of Micronesia for Improving Capacity in Performance-Based Public Finance Management*. Manila (TA 3431); ADB. 1998. *Technical Assistance to the Federated States of Micronesia for Performance-Based Public Resource Management*. Manila; and ADB. 1996. *Technical Assistance to the Federated States of Micronesia for Improved Budget Management*. Manila.

phases: (i) development of national and state long-run adjustment/sustainable transition plans, and (ii) strengthening and interlinking of national planning and budget cycles. The implementation of phase 2 at the national and state levels will depend on the achievement of specific short-term benchmarks identified in the national and state long-run adjustment/sustainable transition plans developed in phase 1.

14. Phase 1 will have as its outputs national and state transition plans and a governance arrangement to oversee the TA. Activities in this phase will comprise (i) development of national and state long-run adjustment/sustainable transition plans to move to a sustainable balance of government revenue and expenditure and cut fiscal deficits; and (ii) creation/identification of steering committees at national and state levels to oversee the implementation of the TA and to sustain the processes developed beyond the implementation period of the TA. TA steering committees will be created by each government and will comprise relevant public sector representatives. The committees will also be responsible for monitoring and coordinating related funding agency assistance.

15. The adjustment/sustainable transition plans developed in phase 1 will each include a small number of specific financial and/or macroeconomic benchmarks for achievement within 1 year. Achievement of the benchmarks, thus demonstrating the commitment of governments to the objectives of the TA, will be a prerequisite for implementation of phase 2 at each of the national and state levels.

16. Phase 2 will have as its outputs prioritized short-term action plans at national and state levels, interlinked budget and planning cycles at national and state levels, strengthened capacity of relevant public sector officers to implement the plans, and strengthened processes and capacity for performance-based budget implementation and monitoring.

17. Activities in phase 2 will comprise (i) assessing progress in implementing the SDP; (ii) developing achievable rolling priority action plans covering periods of 3–5 years for national and state implementation, building on earlier planning assistance to the FSM; (iii) developing an annual cycle of planning review linked to the budget cycle, which supports inclusion of action plan priorities in the national/state budgets for funding and which seeks to update the rolling action plans and monitor progress toward SDP implementation; (iv) holding a series of practically oriented, participatory public sector workshops in all states to develop awareness and understanding of the operation and implications of the interlinked performance-based budget and planning cycles and to build capacity in support of sustained implementation; (v) assessing the existing budget process and practices at national and state levels with a view to identifying weaknesses, and highlighting opportunities for strengthening the performance focus of the budgets; (vi) developing the necessary procedures and administrative guidelines to allow the implementation of a strengthened performance-based budgeting system, which, as far as possible, is consistent across governments; and (vii) generating demand within state legislatures and the national Congress by conducting seminars and workshops to build awareness and understanding of the use of performance information for policy-based decision making.

18. A number of assumptions are important to the success of the TA. The tightened financial position facing the FSM, in combination with the leadership changes coming from the 2007 elections, creates an environment conducive to tackling the weak budget and planning processes that are constraining growth. It is assumed that this supportive environment will be maintained. The greatest risks to the TA's success include (i) weakening of political support for implementing expenditure cuts, which will necessarily arise in a situation where performance

becomes a more important basis for budget allocation and revenue streams remain static; and (ii) failure to attract and retain suitable capacity at both national and state levels to follow through with implementation of the strengthened budget and planning processes.

C. Cost and Financing

19. The total cost of the TA is estimated at \$475,000 equivalent. Of that amount, \$400,000 will be financed on a grant basis by the Japan Special Fund, funded by the Government of Japan. The Government of the FSM will finance \$75,000 equivalent in kind through the provision of counterpart staff, office accommodations, and local communication. Details of the cost estimates and financing plan are in Appendix 2.

D. Implementation Arrangements

20. The Department of Economic Affairs (DEA) will be the Executing Agency, while implementing agencies will include Department of Finance and Administration (DFA) and state budget and planning offices. Under DEA, the TA focal point will be appointed, who will supervise the activities of and liaise with the consultant team. The TA focal point and the team will work with the Government through steering committees at both national and state levels. The consultants will also consider the outcomes of related activities by other funding agencies, and with the TA focal point liaise with relevant funding agency projects. The consultants will also liaise with the DFA's taxation reform project manager to promote coordination and complementarities in activities. Coordination with the taxation reform project manager is particularly important as the implementation of the taxation reform project will have implications for national and state budgets and the ability of the FSM to implement its SDP.

21. The TA will be implemented intermittently over a 3-year period, starting in October 2007 and ending in September 2010. Phase 2 should begin implementation by November 2008, depending on achievement of the identified short-term benchmarks. The TA will finance 12 person-months of international consulting services. The proposed consultants will be (i) a public financial management specialist/team leader (international, 9 person-months, intermittent); and (ii) a national planning specialist (international, 3 person-months, intermittent). ADB will engage the consultants individually based on their qualifications and in accordance with ADB's *Guidelines on the Use of Consultants* (2007, as amended from time to time). Appendix 3 gives the outline terms of reference.

22. An inception report will be prepared for ADB by the team leader within 2 weeks of the start of field activities, a phase 1 implementation report by December 2007, a phase 2 readiness assessment by October 2008, a phase 2 work-in-progress report by August 2009, and a draft final report by August 2010. The final report is to be submitted within a month of the incorporation of ADB comments on the draft final report.

IV. THE PRESIDENT'S DECISION

23. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$400,000 on a grant basis to the Government of the Federated States of Micronesia for Strengthening Economic Management and Planning, and hereby reports this action to the Board.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
<p>Impact Support the implementation of the SDP and its goal of economic self-sufficiency</p>	<ul style="list-style-type: none"> • National and state balanced or surplus budgets by FY2010 • Progress toward SDP goals monitored and on target by FY2010 	<ul style="list-style-type: none"> • National and state budget data FY2009 • SDP monitoring reports • JEMCO reports • Development partner assessment reports 	<p>Assumptions</p> <ul style="list-style-type: none"> • Governments implement the transition plans developed. • Governments adhere to strengthened budget and planning processes. • Capacity to support implementation is attracted and retained at national and state levels.
<p>Outcome Interlinked budget and planning processes supporting sustainable economic development</p>	<ul style="list-style-type: none"> • Funding of identified priority development activities at national and state levels in FY2010 budget 	<ul style="list-style-type: none"> • National and state budget data • SDP monitoring reports • JEMCO reports 	<p>Assumptions</p> <ul style="list-style-type: none"> • Governments' commitment to strengthened performance-based budgeting is maintained. • Governments adequately resource budget/planning functions.

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
<p>Outputs</p> <ol style="list-style-type: none"> 1. National and state transition plans 2. National and state steering committees to oversee the TA 3. Prioritized short-term action plans at national and state levels 4. Interlinked budget and planning cycles 5. Strengthened capacity of budget and planning officers 6. Strengthened processes for performance-based budget implementation and monitoring 	<ul style="list-style-type: none"> • National and state transition plan benchmarks achieved • Steering committees meeting regularly as per mandate • National and state action plans adopted and priority activities implemented on schedule • Priority action plan items included in budgets • Counterparts actively engaged in budget development and planning review • National and state adoption of guidelines/framework 	<ul style="list-style-type: none"> • National and states FY2009 budget outcomes • TA review/ completion mission BTORs • TA progress and final reports • Documentation prepared under TA for national and state government use 	<p>Assumptions</p> <ul style="list-style-type: none"> • Government is committed to budgetary/planning reform. • There is good cooperation among consultants and government agencies. <p>Risks</p> <ul style="list-style-type: none"> • Qualified consultants are not recruited in a timely manner. • Governments fail to retain suitable counterparts.
<p>Activities with Milestones</p> <ol style="list-style-type: none"> 1.1 Develop national and state transition plans (December 2007) 1.2 Submit inception report (November 2007) 1.3 Submit phase 1 implementation report (December 2007) 1.4 Submit phase 2 readiness assessment (October 2008) 1.5 Submit phase 2 work-in-progress report (August 2009) 1.6 Submit final report (August 2010) 2.1 Create TA steering committee with national and state representation (October 2007) 			<p>Inputs</p> <ul style="list-style-type: none"> • ADB \$400,000 and 4 person-weeks staff time for missions and review of the TA reports • Government \$75,000

Activities with Milestones	Inputs
3.1 Report on progress in SDP implementation	
3.2 Develop 3- to 5-year rolling priority action plans for national and state implementation	
4.1 Develop an annual cycle of planning review linked to the budget cycle	
5.1 Conduct participatory public sector workshops in all states on the interlinked performance-based budget and planning cycles	
6.1 Assess the existing national/state budget processes and practices	
6.2 Complete performance-based budgeting procedures/ guidelines	
6.3 Hold seminars and workshops for state legislatures and National Congress on the use of performance information for policy-based decision making	

ADB = Asian Development Bank, BTOR = back-to-office report, FY = fiscal year, GDP = gross domestic product, JEMCO = Joint Economic Management Committee, SDP = Strategic Development Plan 2004–2023, TA = technical assistance.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Total Cost
A. Asian Development Bank Financing^a	
1. Consultants	
a. Remuneration and Per Diem of International Consultants	300.0
b. International and Local Travel	35.0
c. Reports and Communications	15.0
2. Training, Seminars, and Conferences	10.0
3. Miscellaneous Administration and Support Costs	5.0
4. Contingencies	35.0
Subtotal (A)	400.0
B. Government Financing^b	
1. Office Accommodation and Transport	25.0
2. Remuneration and Per Diem of Counterpart Staff	50.0
Subtotal (B)	75.0
Total	475.0

^a Financed by the Japan Special Fund, funded by the Government of Japan.

^b Government of the Federated States of Micronesia financing.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. Consulting services will support the two phases of this technical assistance (TA). The team of consultants will comprise (i) a public financial management specialist, and (ii) a national planning specialist. The team leader/public financial management specialist will supervise and lead the work in both phases. The consultants are expected to work closely with each other so that the TA will stay in line with its scope, and each phase will be coherent.

2. The two consultants should maintain close contact with the Asian Development Bank (ADB) project officer, and the executing and implementing agencies throughout the execution of the TA.

1. Public Financial Management Specialist/Team Leader (international, 9 person-months, intermittent)

3. The specialist will have a strong background in expenditure management, especially performance-based budgeting, capacity building and training, and project/program development and management. The specialist should (i) have at least 10 years experience in advising a variety of Pacific governments and societies in his/her expertise; (ii) hold a tertiary degree, preferably a master's degree or PhD, in finance, economics or a related field; and (iii) have excellent communication skills, especially in writing.

4. The assignment of the public financial management specialist/team leader, working closely with the national planning specialist, will include, but is not limited to, the following tasks.

- (i) Work with the Executing Agency to create a steering committee with appropriate national and state representation to oversee the implementation of the TA and to sustain the processes developed beyond the life of the TA.
- (ii) In consultation with the TA focal point and steering committee, develop a detailed work plan for the TA, which seeks to build on and complement earlier and ongoing related assistance.
- (iii) Assess the budget process and practices at national and state levels with a view to identifying weaknesses and highlighting opportunities for strengthening the performance focus of the budgets.
- (iv) For the national and state governments, as required, develop transition plans to move to sustainable budget positions.
- (v) Support the strengthened implementation of performance-based budgeting in government departments and agencies at the state and national levels and in the national Congress and state legislatures, by providing seminars and workshops.
- (vi) Develop national and state frameworks for budget monitoring that include benchmarks/targets for governments' attention and which are linked to the rolling 3- to 5-year action plans supporting implementation of Strategic Development Plan 2004–2023 (SDP).
- (vii) Recommend the best mechanism, including a legislative requirement, for interlinking the budget and planning processes at national and state levels.
- (viii) Advise the steering committee on any issues within the scope of the TA.
- (ix) Collate and prepare inception, midterm, draft final and final reports as required by ADB.
- (x) Provide intellectual leadership and guidance in implementing the TA.

2. National Planning Specialist (international, 3 person-months, intermittent)

5. The national planning specialist will have a strong background in national and strategic plan development, and implementation review and monitoring. He/she will have extensive experience in technical assistance in those fields in small island developing states and other resource-constrained countries.
6. More specifically, the national planning specialist will undertake these tasks.
 - (i) Based on a review of primary and secondary sources, assess the progress in implementing the SDP of the Federated States of Micronesia.
 - (ii) Working closely in a participatory and consultative manner with counterparts at the national and state levels and building on earlier planning assistance, develop rolling priority action plans, utilizing existing performance measures and indicators where available, covering 3- to 5-year periods for national and state implementation, as appropriate, prioritizing programs/projects in the SDP.
 - (iii) Work with national and state counterparts to develop an annual cycle of planning review linked to the budget cycle, which supports inclusion of action plan priorities in the budget for funding and which seeks to update the rolling action plans and monitor progress toward SDP implementation.
 - (iv) With the public financial management specialist, prepare and facilitate a series of participatory public sector workshops in all states to develop awareness and understanding of the operation and implications of the interlinked performance-based budget and planning cycles.