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Republic of the Marshall Islands – A Private Sector Assessment

Promoting Growth Through
Reform

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RETA 6037: PRIVATE SECTOR DEVELOPMENT STRATEGY FOR THE PACIFIC

This report was written by Paul Holden and Sarah Holden.

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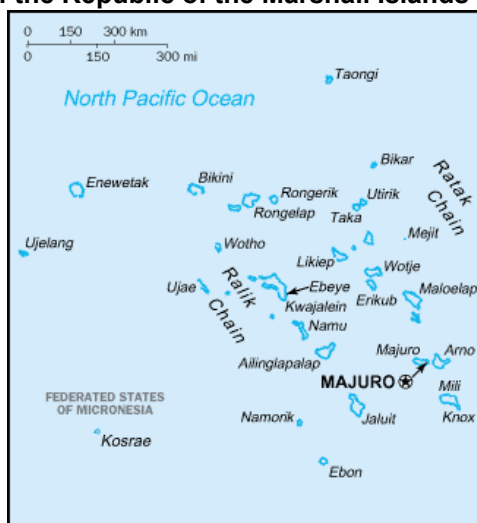
I. Diagnosis & Synopsis

A. Introduction

Figure 1. Map of the Republic of the Marshall Islands¹

1. The Republic of the Marshall Islands (RMI) economy has registered many years of low or negative growth and per capita income is now 20 percent below what it was at independence. The government has announced that future growth depends on a thriving private sector and is interested in promoting private sector friendly policies within a sustainable development framework.

2. This private sector assessment (PSA) examines the environment for doing business in RMI. Based on numerous interviews with private sector business people, it concludes that although the government has made the important commitment to improving the private sector environment, several important steps are necessary to improve the prospects for higher private sector growth. The PSA suggests policy initiatives to promote private sector growth by making it more competitive, changing some aspects of the role of the state in the economy and undertaking institutional reform that will promote private contracting and encourage financial market growth. The report concludes that the time is ripe for a national debate regarding the role of the state, the role of business and how reform should proceed.



¹ CIA World Factbook, 2003

1. Can There be Private Sector Development in RMI?

3. Many have questioned the viability of Micronesian economies, claiming that they do not have potential for development of the private sectors of their economies. This view concludes that attempting reforms to promote private sector development is therefore futile. In the opinion of the authors of this private sector assessment, such views are overly pessimistic for two reasons. First, there are examples of small isolated economies that have done extremely well – Norfolk Island, the Falkland Islands, Mauritius, Iceland, and Bermuda are examples of prosperous economies that have developed because of a vigorous private sector under circumstances that are not very different to Micronesian nations. Second, the Micronesian economies have been hampered by the policies of the past, in terms of which the State plays a prominent role and dominates the economies of the islands. These policies have not worked. Large inflows of aid appear to have had, at best, a marginal impact and poverty remains commonplace.

4. Furthermore, the implication of the view that private sector development can only play a minor role in the economies of Micronesia is that its peoples are doomed to continued dependence on donors. Not only does this force Micronesians to rely on the goodwill of outsiders, it places their economic future beyond their control and pushes this group of countries into a dependency relationship with donors. While the success of private sector development policies cannot be guaranteed with total certainty, private sector led growth has a better chance of achieving prosperity than the policies of the past. Furthermore, a policy directed towards promoting self reliance and initiative is a far healthier and more sustainable than one that condemns the Micronesian Island economies to hoping for the continued contributions of the donor community.

B. The Main Issues

5. The main issues influencing private sector development in the Marshall Islands are:
- *A Stagnant Macroeconomy.* There has been no sustained growth in RMI since independence in 1986. There is no real discretionary control over macroeconomic instruments. The Marshall Islands' rate of inflation is tied to that in the United States as is the preponderance of its trade. With few or no discretionary instruments at its control to influence the economy, the stagnation of output is a result of the poor incentives provided by the very high cost business environment.
 - *A Low Rate of Return on Capital.* Indirect evidence suggests that the rate of return on capital in RMI is low which has resulted in the private sector being a net exporter of capital. The most likely explanations are the crowding out of the private sector by the state, weak institutions and the high cost business environment.
 - *A Costly Business Environment.* A number of factors combine to raise the costs of doing business in the Marshall Islands, including utility costs, poor infrastructure, the high costs of communications and high import duties. Most of these costs arise from the pervasive influence of the state in the economy and together they greatly exacerbate the impact of the small size and the remoteness of RMI.
 - *Concentrated Economic Power.* The small size of the economy has led to a concentration of economic power in the services and distribution sectors, which has decreased competition and increased costs. Lack of competition is exacerbated by the fact that in a small economy like RMI, many prominent businessmen and politicians often wear both private and public "hats" moving between the private and public sectors, so that there is a blurring of roles along with potential significant conflicts of interest. Although the influx of entrepreneurs from Asia is having a positive effect by increasing competition, it has resulted in increased societal tensions as well as accusations of tax and regulation avoidance.
 - *Underdeveloped Financial Markets.* The institutional foundation of financial markets in RMI is very underdeveloped. Property rights in land are uncertain because of communal ownership and movable property rights, the basis for pledging assets as collateral against

lending, are very weak. The result is that lending for business support occurs only to those who have substantial assets. Other important financial market issues include possible regulatory concerns with the largest commercial bank on the island and the poor state of the development bank.

- *Limited Business/Government Consultation.* Discussions with both the government and private sector in RMI revealed disturbing differences in understanding, agreement, and the goals and obligations of the government and private sector in a market economy. In the longer term, this situation will harm economic development. The report recommends strongly that the parties involved devise a forum for regular consultation to promote the development of a common vision for private sector development, and ultimately the growth and prosperity of the Marshall Islands. Private sector strategy is not about fostering specific companies or sectors. It is rather about ensuring that the incentives and conditions that affect business and entrepreneurship promote productivity and growth. As a result, private sector issues encompass almost every area of the economy. Moreover, the government is not the only one responsible for implementing a strategy to encourage private sector development. The private sector itself must play a central role in formulating policy. And in the process, both the government and the private sector have responsibilities. The government has an obligation not to erect barriers to business and commercial activities. The private sector has an obligation not to expect preferences, handouts, and special support from the government.
- *Private Sector Development in the Outer Islands:* This paper examines and describes the impact of various factors that inhibit private sector growth in RMI. Since most private sector activity occurs in the larger population centers, the analysis focuses on issues that exist there. However, the conclusions apply equally, if not more strongly, to the outer islands. High cost, poor or non-existent infrastructure in an already isolated environment has a disproportionately large impact. Unreliable transport facilities has a devastating effect on initiatives to increase trade, not only with the outside world, but also within the islands themselves. Tourism cannot grow if air service does not exist. Factors that

inhibit private sector development in the main centers have an even larger impact in isolated communities.

C. The Role of the State in the Economy

1. Weak Institutional Foundation for Private Sector Development

6. In most Pacific region countries, the institutions that underlie a modern market economy – commercial law, property rights for land and movable property, the court system, effective regulation, and an open trade regime - are weak and do not support private sector activity effectively. The Marshall Islands is no exception. The state is not providing the foundations for private sector development, is harming the private sector through an inefficient tax and import regime, and is crowding out the private sector in a number of areas.

2. The Role of the State in the Economy

7. The state plays a pervasive role in the economy. Despite a program to downsize public sector employment, including closure of the Ministry of Public Works², the State continues to employ a substantial proportion of the workforce. Indications are that public sector wages are higher than those in the private sector and are unrelated to productivity. Many private sector operators interviewed for this report complained that the government drives up wages and salaries to the point where it is difficult to find workers at competitive wages.

8. RMI has the second highest level of development assistance in the Pacific region, which already has the highest level of aid per capita in the world. The major source of aid is payments under the US Compact. Aid amounts to the equivalent of about 35 per cent of GDP. It is striking that the very high levels of aid have not resulted in any growth in the economy over the past 15 years and that in spite of the aid, per capita GDP has declined.

² The Ministry of Public Works was closed down as part of a public sector reform program that was assisted by the ADB. Maintenance of public infrastructure was taken over by private sector operators and maintenance improved substantially. Following elections, however, the Ministry was reopened and according to some reports employs nearly as many workers as before the closure.

Part of the explanation lies in the incentives of Compact transfers towards creating a bloated public sector that crowds out private sector activity.

3. State Owned Enterprise Issues

9. There is extensive state ownership of enterprises. Most of them are running at a loss. Even those that are earning positive cash flows cannot generate sufficient earnings to finance capital expenditures. The government sponsored copra scheme, which is used as a means of distributing income to the outer atolls, is accumulating large losses. Furthermore, the incentives inherent in the scheme do not encourage productivity and in the long run are damaging not only attempts to foster private sector initiatives but also negatively affecting attitudes to enterprise in RMI.

10. Government employees and ministers dominate the Boards of Directors of the state owned enterprises (SOEs.) This situation precludes impartial oversight of the SOEs, and it does not provide commercial assistance to the enterprises. In addition, the perks of board membership weaken the incentives to promote privatization. However, even when government puts the running of SOEs in private hands, the contracts do not appear to be on a competitive bid basis and it is difficult to obtain a clear picture of the financial relationships involved. Since RMI is a small economy, ensuring competitive bids is probably difficult, given the limited number of companies that might have the capability to run government enterprises. More clearly defined operating and efficiency standards, however, appear to be needed.

4. Policy Recommendations

- The guiding principle of SOE operation should be to supply the service as efficiently and cheaply as possible. It should *not* be to maintain employment or preserve monopolies. Wherever possible, private operators should be allowed to compete on equal terms with SOEs. This report suggests that this principle become the operating criteria for all SOEs in RMI.
- A comprehensive plan for the future of SOEs in the Marshall Islands is required. As a first step, placing all SOEs under one administrative umbrella is essential. For example,

all SOE Boards might report directly to the Minister of Finance who would then have the responsibility for ensuring efficient operation. Such a move would eliminate the current situation of conflicting standards and operating criteria arising from SOEs being the responsibility of a range of ministries.

- The management and oversight of the SOEs requires centralization to ensure consistent standards and operating procedures. A plan for each SOE is necessary to decide how to improve their operating efficiency and reduce the budgetary drain.
- Governance standards regarding board composition and functions, for example in relation to conflict of interest, qualifications for Board membership and length of tenure are required to strengthen the oversight of SOEs.
- The government needs to develop standards and oversight for contracting out the running of SOEs to private sector operators. This report recommends that ADB be approached for technical assistance.
- The government should abolish indirect subsidies, such as the diesel fuel exemption accorded to MEC, as part of establishing SOEs on the same operational footing as private sector companies.
- The copra price subsidy is unsustainable, provides perverse incentives and its budgetary impact is unsustainable. In the long run it is damaging productivity and private sector development in the outer islands. This report accepts fully that the outer atolls require income transfers but the copra price subsidy is an ineffective way of doing this. It is the strong recommendation of this report that the government explore alternative income transfer methods and completely privatize copra buying.

D. Financial Markets in the Marshall Islands

11. The Marshall Islands has severely underdeveloped financial markets. There are only 3 banks. (One is the Marshall Islands Development Bank that is in a precarious financial position and not lending.) Interest rates are high – in the region of 15 – 18 percent in real terms and the term of any loans is short. Lenders spoke of the high risks of lending, a concern that is understandable given the difficulty of obtaining secure collateral on loans.

12. The largest bank, the Bank of the Marshall Islands, dominates the financial sector lending over 60 percent of all private sector credit. There are a number of concerning issues, however:

- Senior officers of the bank are also in business on their own account and private sector operators expressed concern about showing business plans to actual or potential competitors that happened to be bank officials.
- Bank shareholders are planning to establish a holding company that will own the bank and at the same time other businesses. This situation has, on occasion, been a recipe for financial problems in other countries.

13. The Marshall Islands Development Bank is experiencing the usual problems of development banks elsewhere. It has a high proportion on non-performing loans and is currently not lending. In any case, it has been violating its mandate to lend for development by lending primarily for consumer loans. This report recommends that the Bank be either privatized or closed.

14. There is interest in initiating a microcredit facility in the Marshall Islands, a scheme that could have substantial potential. But, there is a potential problem because usury laws impose a ceiling on lending charges at an effective nominal interest rate of 24 percent per year. This amount is below the minimum sustainable level of successful microcredit institutions in other countries.

1. Policy Recommendations

- There are potentially serious regulatory issues with the largest bank in the Marshall Islands that need to be examined.
- Usury laws need to be addressed if RMI expects to establish a sustainable microcredit institution.
- No significant reform of the financial sector in the Marshall Islands will be possible until the collateral framework for lending is addressed (see the next section on institutions.)
- The recent proposals to supply subsidized funding to private businesses in RMI is most decidedly not in the best interests of the long term development of the private sector in the RMI economy. Providing failing businesses with funding has rarely been successful in other parts of the world and is unlikely to be successful here. The usual outcome is that the businesses fail anyway and the government loses its funds. The private sector is a net exporter of capital, which indicates that it does not have confidence in the long term profitability of investment in the Marshall Islands. Until the government improves the environment for private sector development, this will continue.

E. Institutions & Private Sector Development

15. Ultimately, private sector activity in RMI or elsewhere is driven by the environment in which it operates. The incentives that business people face are determined by the institutions that influence private sector activity and the transactions costs imposed on their businesses. Important elements include:

- The institutions that provide the basis for private sector activity such as: the legal system, the financial system, and infrastructure provision.
- Governance and political stability.
- Within the legal system: the viability of property rights and contracting within that system, and the dispute resolving mechanisms.
- Within the financial system: the ability of businesspeople to raise capital.

16. Ultimately, factors such as natural resource endowments (fishing in the case of the Marshall Islands), education levels, macro stability, and savings rates have little impact *in themselves* if the underlying institutional framework is missing.

17. In the Marshall Islands, institutions such as the legal and financial system are weak and fail to provide the foundations for private sector activity that are fundamental to private sector growth. In addition, transactions cost are high and there are many barriers to entry for small businesses and little benefit from being formal. The private sector cannot prosper in an environment that does not provide capital and financing for entrepreneurial activity. The remainder of this chapter examines these issues in more detail.

1. Land Tenure Issues

18. Good land tenure systems³ do not provide the foundation for a growing private sector in the Pacific region, and the Marshall Islands is no exception. An ADB technical assistance project is about to begin that will start the process of land reform. The challenge is to find ways to integrate the communal/traditional land tenure system into the economy in ways that are compatible with both tradition and modern (liberal) economic practices.

19. Since a major portion of the wealth of Marshall Islanders lies in their property, the fact that they cannot use it as security to finance improvements puts them at a significant disadvantage. Furthermore, since corporate “personas” cannot own land, a lease is more useful as security than a title. The land tenure problems in RMI arise from:

- Unclear ownership and boundaries largely because of lack of recording.
- Restrictions on the transferability of land (mandated because of unclear ownership.)
- Unclear definition of the different land tenure rights.
- Weak (and unrecorded) dispute resolution practices.
- Problems of enforcement.

³ Land tenure is defined as the rules of possession, use, and conveyance of land.

20. If the upcoming technical assistance to reform land rights covers part of these issues, it will have made a promising start in the reform of land rights in the Marshall Islands.

2. Secured Lending & Movable Property Rights

21. The Marshall Islands also has no effective framework for secured lending against movable property. There is no way of registering a security interest in movable property, let alone ensuring that there are no prior claims on the assets being offered as security - there are no registries, even for automobiles. Finally, repossession in the event of default takes months or even years. While banks do take some assets as security, they place little store by it and require a large multiple of the value of the loan. In essence, the secured transactions framework is deficient.

22. The legal framework for secured lending needs to be clarified and updated. The new system must mesh closely with a customary system of land rights yet permit more land to serve as collateral. This arrangement requires a diagnostic study and the preparation of a draft law to focus discussion of the issues. Developing a consensus is a necessary part of the process but it will take time. It needs to commence now.

3. Commercial Codes

23. The commercial laws underlying private sector transactions in RMI are outdated and unsuited to modern business practices. Many of them date from the 1960s and 1970s and are based on US commercial codes from the 1950s. A particular problem is that there is no bankruptcy code. There is a provision by which companies can elect to close themselves down, but there is no law through which creditors can apply to the court for liquidation and sale of assets of companies that are unable to pay their debts.

24. A further problem is the haphazard codification of laws governing business transactions. It is extremely difficult to obtain information on the laws that have actually been passed and combing Parliamentary minutes to obtain information, as difficult as it is, is frequently the only way to obtain information on rules that apply to particular commercial transaction. Similarly, obtaining information on precedent from legal rulings is difficult and costly, which contributes to the high costs of doing business in the Marshall Islands.

25. This report recommends that ADB assist the government of the Marshall Islands to update its commercial code and codify the laws that apply to commercial transactions. Since secured transactions reform requires reform of the commercial code, this report recommends a complete overhaul of laws governing commercial transactions.

4. Foreign Investment Issues

26. Companies reported difficulties and delays in obtaining permits for foreign workers. Like other PDMCs, RMI is critically short of skills of all types - one of the reasons for the region's low productivity. Yet, it is difficult to obtain work permits for foreigners possessing such skills. This policy has a perverse effect. It drives down overall productivity levels, thereby keeping salaries low which in turn encourages emigration of skilled Marshall Islanders. Reluctance to approve work permits for foreign workers is based on what is known as the "lump of labor fallacy," namely that there is a limited amount of work to be divided among the workforce. In terms of this fallacy, it follows that if a worker is brought in from outside, a local must lose a job. The reality is far different, however. A skilled worker will raise productivity and create output and jobs for the local population. The Marshall Islands should welcome any skilled foreigner with open arms. Rather than making it difficult for businesses to bring in skilled workers, processes should be simplified and expedited.

27. Similarly, the fastest way to upgrade business practices is to learn them from foreign investors. Although the Marshall Islands has improved the laws governing foreign investment, there are still substantial administrative delays.

5. Policy Recommendations

28. The conclusions of the analysis of the institutional framework for private sector development in the Marshall Islands are that the government:

- Pursue the land reform program as quickly as feasible bearing in mind the principles of reform outlined above.

- Must establish a secured transactions framework at the same time as reforming the law, installing a transparent registry, and introducing extra judicial repossession in the event of default.
- Update commercial codes as well as codify the laws governing business transactions.
- Remove any restrictions on the entry of foreign workers to improve skills transfer.
- Review foreign investment laws to remove the administrative delays that exist currently.

F. Sector Issues

1. Tourism

29. Tourism is an obvious target for increasing both earnings from abroad as well as raising employment opportunities. Currently, however, the number of genuine tourists is very low – by some counts in the region only 1000 per year. There is a low awareness of RMI in the outside world, it is expensive to get to there and Majuro is not an attractive destination because of the garbage and lack of facilities. Since going to the outer islands is also costly due to the high charges of the domestic airline, the travel costs associated with a trip to RMI are high. Although there are wonderful resources in the outer islands, the cost benefit ratio for tourists is not competitive relative to other destinations.

30. The Marshall Islands Visitors Authority is trying to promote tourism. Its current budget per genuine tourist implies an expenditure of \$300 per visitor. A substantial portion of the expenditure, however, goes toward paying salaries at MIVA. Targeted expenditure in a small number of markets, with a reduction in personnel costs is probably the best way to achieve increases in tourism numbers.

2. Fishing

31. The Marshall Islands gains significant revenue from the licensing of foreign fishing vessels to catch fish in its economic zone. Although there were complaints about the failure to interdict vessels that were fishing illegally, the process appears to be working reasonably well.

32. In addition, the local economy generates significant jobs through the tuna loining plant, which employs approximately 400 people. The plant is owned by a US shipping company, and is financed by bank loans that have been guaranteed by the Marshall Islands Marine Resource Authority. In addition, it has tax benefits and an abrogation from the provision of the labor laws. But it is concerning that the plant has yet to establish commercial viability. After more than three years of operation, it has not made a profit, (although the extent of transfer pricing is unknown), and is substantially short of achieving projected levels of output. In spite of this, however, it is considering expanding.

33. The main justification for the subsidy of the loining plant is that it generates significant employment. At the wages that it pays, however, it has difficulty maintaining a stable workforce – labor turnover is very high. It appears that workers are happy to move in and out of paid employment.

3. Policy Recommendations

34. This report recommends that the government should :

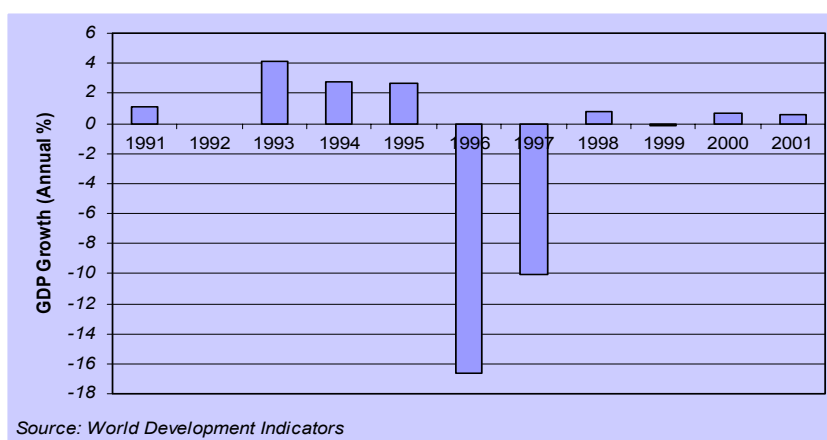
- Review tourist promotion policies, including the effectiveness of current expenditures. There needs to be narrower targeting, increased budgets for advertising, and a reduction of personnel by the tourism promotion authority. These actions have the potential to increase the number of genuine tourists beyond the current very low numbers thereby increasing tourism revenue and potentially developing new jobs. (These activities must be completed in conjunction with the other recommendations of the report to ensure that the appropriate enabling environment is established for the tourist industry.)
- Grant no more subsidies to the tuna loining plant to support further expansion. The plant must establish financial sustainability on its own.

II. Overview of Private Sector Issues

A. Introduction

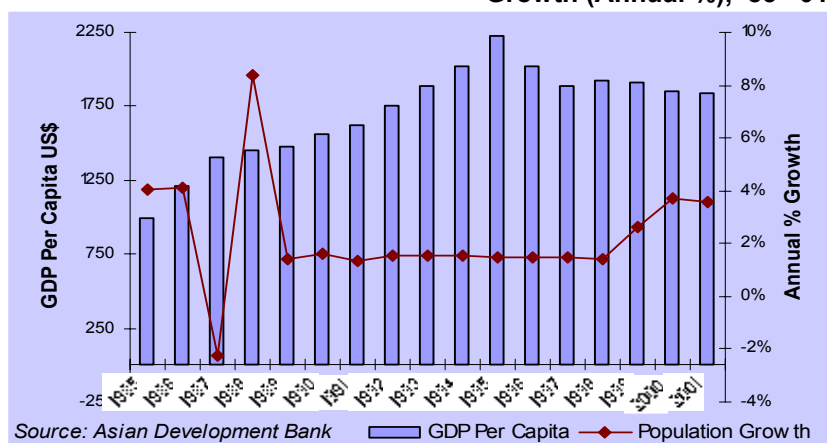
35. The Marshall Islands (RMI) economy has exhibited no significant growth over the past few years and by some estimates real GDP is hardly different from what it was at independence in 1986.

Figure 2. GDP Growth, Annual %, 1991 – 2000



There were small increases in GDP in the first half of the 1990s followed by very sharp declines in 1996/1997 when government budgetary problems caused sharp cutbacks in public expenditure. Since then, there have been further very modest increases in GDP. Since the population has increased significantly, per capita GDP appears to have fallen by over 20 percent in the 1990 – 2002 period. The sharp rise in population growth will result in a rapidly growing labor force, so that future employment prospects are dim. Although emigration, mainly to the

Figure 3. GDP Per Capita (US\$) & Population Growth (Annual %), '85-'01



United States, has provided a safety valve, the government is increasingly concerned about the medium term growth and employment outlook and has stated

encouragingly that private sector development is essential for the future prosperity of the country.

36. This private sector assessment (PSA) analyzes the business environment in RMI. It looks at the enabling environment for commercial activity, the financial sector, the role of the state within the context of its effect on the private sector, and how infrastructure, communications, and transportation issues impact the environment for doing business. It examines briefly the property rights regime, both for fixed and movable property, and how they impact private sector development. Finally, it appraises the legal and regulatory environment and whether they support the private sector.

37. The conclusion of the PSA is that doing business in the Marshall Islands is difficult. The small economy, in which prominent people move in and out of government, problems with property rights, and the laws related to business transactions make arms length contracting almost impossible and finance very difficult to obtain. The prominent role of the state, in the economy, bolstered to a large part by Compact Payments, raises costs for business and crowds out employment and entrepreneurship. The impact of state intervention augments the negative effects of isolation, size, and vulnerability of the country, which are further compounded by a trade regime that is characterized by variable tariff rates and taxes on imports on which there are many exemptions. This situation has resulted in an atmosphere of tension and mistrust between government and the formal private sector. At the same time, the institutions and incentives inherent in the current system put native born Marshallese at substantial disadvantage in doing business. The problem is not the result of discrimination or exclusion, but rather because the interaction between property rights on the one hand and the financial system on the other disbars most of the local population from even the possibility of mobilizing their wealth to finance business ventures. Furthermore, the incentives faced by Marshallese in the outer atolls, especially the government-sponsored copra purchasing scheme, do not encourage entrepreneurial activity.

38. In the view of the authors, the time is ripe for a national debate regarding the need for private sector development within the context of the role of markets and competition in promoting prosperity. Such a debate should also encompass the appropriate role of the state, the role of business, and how reform should proceed.

B. The Main Issues

39. This report examines the incentives faced by business and the problems that underlie the failure of the country to grow. The key issues identified and discussed at length include:

- *A Stagnant Macroeconomy.* Although detailed macroeconomic issues are outside the purview of this report, except to the extent that there is a direct impact on private sector development, the stagnant macroeconomy has affected business in general. The continued failure of the economy to grow is taking a substantial toll on businesses as well as entrepreneurial expectations. This situation is a result, rather than a cause, of the inadequate business environment in RMI. Since the US dollar is the national currency, the inflation rate of the Marshall Islands is the same as that of the United States⁴. There is no possibility of discretionary monetary policy and fiscal policy is limited by the budget constraints stemming from the desire of government to stabilize public sector finances. The failure of the economy to grow is therefore a result of the microeconomic incentives that exist within RMI.
- *A Low Rate of Return on Capital.* Although there are no formal calculations, casual observation, discussion, and the substantial export of private capital, all indicate that rates of return on investment in the Marshall Islands are low. The costly environment in which to do business plus the crowding out by the state of the private sector are the two most plausible explanations.

Table 1. Foreign Direct Investment Outflows (Millions US\$)

	1996	1997	1998	1999	2000
RMI (Net private capital flows)	-31.2	-6.0	-1. 2	-16. 8	-14.7

Source: Asian Development Bank

⁴ Much confusion exists regarding the effect on prices of RMI having the dollar as the national currency. Basically using the US dollar means that the rate of inflation will be the same but the price level may well be different in the way that cities within the United States may be more or less costly but rates of inflation over the long run do not differ. The isolation of the Marshall Islands implies that the price of non-traded goods can differ substantially from the United States.

- *A Costly Business Environment.* A number of factors combine to increase the costs of conducting business in the Marshall Islands, including utility costs, poor infrastructure, the high costs of communications and high import duties. Together, these factors exacerbate the impact of the small size and the remoteness of the Marshall Islands.
- *Concentrated Economic Power.* The small size of the economy has led to a concentration of economic power in the services and distribution sectors, which has decreased competition and increased costs. Although the influx of entrepreneurs from Asia is having a positive effect by increasing competition, it has resulted in increased societal tensions as well as accusations of tax and regulation avoidance. This issue is addressed at greater length in a later section.
- *Undeveloped Financial Markets.* The institutional foundation of financial markets in RMI is very underdeveloped. Property rights in land are uncertain because of communal ownership and movable property rights, the basis for pledging assets as collateral against lending, are very weak. The result is that lending for business support occurs only to those who have substantial assets. Other important financial market issues include possible regulatory concerns with the largest commercial bank on the island and the poor state of the development bank.
- *Limited Business/Government Consultation.* Discussions with both the government and private sector in RMI revealed disturbing differences in understanding, agreement, and the goals and obligations of the government and private sector in a market economy. In the longer term, this situation will harm economic development. The report recommends strongly that the parties involved devise a forum for regular consultation to promote the development of a common vision for private sector development, and ultimately the growth and prosperity of RMI. Private sector strategy is not about fostering specific companies or sectors. It is rather about ensuring that the incentives and conditions that affect business and entrepreneurship promote productivity and growth. As a result, private sector issues encompass almost every area of the economy. Moreover, the government is not the only one responsible for implementing a strategy to encourage private sector development. The private sector itself must play a central role in formulating policy. And in the process, both the government and the private sector

have responsibilities. The government has an obligation not to erect barriers to business and commercial activities. The private sector has an obligation not to expect preferences, handouts, and special support from the government.

C. Overview of the Report

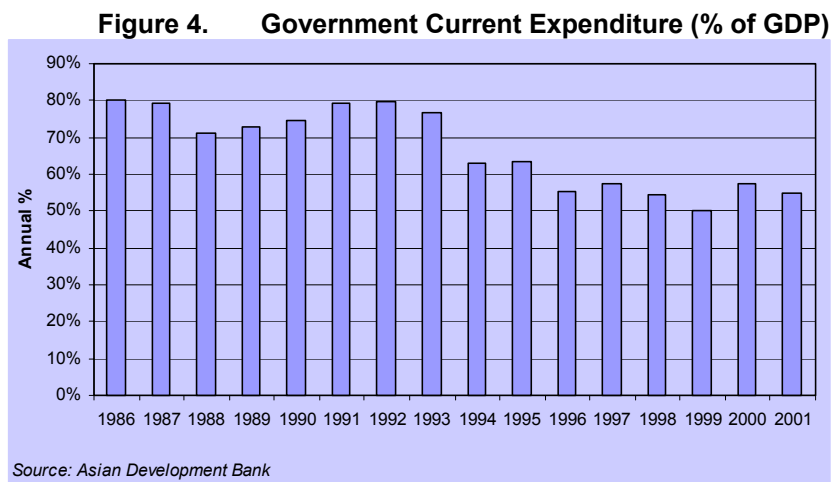
40. In the following sections of the paper, these issues will be elaborated and discussed in greater detail. The organization is as follows:

- Chapter 3 addresses the role of the state in the RMI economy. It discusses the impact of state involvement and concludes that in many areas the state is crowding out the private sector. Costs are higher than they otherwise would be and business uncertainty is increased. The conclusion of the chapter is that the state is not providing the services and institutions that it should and is doing things that it should not.
- Chapter 4 looks at the Marshall Islands financial system. It concludes that it is not intermediating effectively between savers and investors and the lack of competition as well as the absence of an effective collateral system results in very high real interest rates. It points out that reform is required both in the area of property, land and the system of secured transactions that allows movable property to be pledged as collateral. It discusses in some detail the main elements of a system of secured transactions. The chapter also raises some financial system regulatory concerns.
- Chapter 5 discusses the institutional environment in RMI. It points out that the fundamental institutions that underlie business transactions – property rights for land and movable property (chattels), the commercial code for contracting and business transactions, and the dispute resolution mechanisms for contracts are all inadequate as a foundation for modern business transactions.
- Chapter 6 discusses infrastructure issues in RMI. It examines some of the very high costs of infrastructure services and concludes that in a large part they stem from state interference and control in the areas of power generation, telecommunications, and transport.
- Chapter 7 discusses briefly some sectoral issues for tourism, fishing, and the labor market. It makes some suggestions regarding the future direction of sectoral policies.

- Finally, chapter 8 makes some recommendations regarding policies and priorities in the Marshall Islands. Although the list of suggestions is relatively short, actions required to bring about change will be difficult and require significant effort by the government as well as strong support from the donor community.

III. The State & the Private Sector

41. As in most Pacific region countries, the state plays a dominant role in the economy of the Marshall Islands. In expenditure terms, it accounts for more than 50 percent of GDP, although this percentage



has been declining over the past few years as the government has attempted to bring the fiscal accounts into line with US Compact payments.

42. This chapter discusses the state and private sector in RMI. It discusses briefly the role of the state in promoting private sector development. It then examines the impact of the state on the private sector in RMI. It concludes that in several areas, the state is not providing a foundation for the private sector and its interventions hinder business development and entrepreneurship. At the same time, the essential public goods that the state must provide are either absent or inadequate. The chapter discusses these issues and their impact on the private sector in the Marshall Islands. It concludes with some recommendations regarding actions for both short term and long term promotion of private sector development in RMI.

A. The Role of the State in Promoting the Private Sector

43. A flourishing private sector depends on the provision of certain public goods by the state. Broadly, those public goods minimize transactions costs and promote investment and specialization. They include:

- Establishing and safeguarding property rights, both for land and movable property (chattels.)
- Providing an effective foundation for legal contracts and dispute resolution.
- Providing internal and external security against attacks on persons.
- Regulating markets effectively (with a market orientation.)
- Ensuring that infrastructure, communication, and transport infrastructure are efficient and low cost – something that is especially important in small remote economies such as the Marshall Islands where contact with distant countries is the only way in which the country can benefit from the global economy.
- Making sure that imports are low cost and there are no special concessions to particular groups.
- Ensuring macroeconomic stability – the stability of prices and rules (including the predictability of those rules.)

44. Such institutions constitute the foundation of a modern market economy. In most Pacific region countries they are weak and do not support effectively private sector activity. In this, the Marshall Islands is no exception. The state is not providing the foundations for private sector development and at the same time is harming the private sector through some of its actions while crowding out private sector activity through its labor market policies and ownership of businesses.

B. The Role of the State in the RMI Economy

Table 2. RMI Employment Data

1. Government Employment

45. Despite a program to downsize public sector employment, including the closing down of the Ministry of Public Works⁵, the State continues to employ a substantial proportion of the workforce. Indications are that public sector wages are higher than those in the private sector and are unrelated to

LABOR FORCE	YEAR 2000
Total	14,800
Employed	10,300
Agriculture	2,100
Manufacturing	800
Mining	0
Others	7,400
Unemployed	4,500
Unemployment rate	30.4%
State Employees (1999)	1,539

Source: Asian Development Bank

productivity. Many private sector operators interviewed for this report complained that the government drives up wages and salaries to the point where it is difficult to find workers at competitive wages. Since government expenditure is financed primarily from Compact Payments, the effect of the Compact is to crowd out private sector activity.

2. The RMI Government's Provision of Public Goods – General Observations

46. *Infrastructure is in Poor Condition.* The build and deteriorate model of infrastructure provision that is so common in many developing countries exists in full force in the Marshall Islands. Substantial donor funding goes to building infrastructure – maintenance is the responsibility of the government. With the reopening of the Department of Public Works, which is overstaffed and inefficient, the level of maintenance has continued to decline.

47. *Inefficient Inter-Island Transport.* The inter-island airline is overstaffed, costly and unreliable, which hinders the development of a viable tourist industry on the outer islands. In addition, the purchase of inter-island vessels by the government has damaged private sector operators.

⁵ The Ministry of Public Works was closed down as part of a public sector reform program that was assisted by the ADB. Following elections, however, the Ministry was reopened and according to some reports employs nearly as many workers as before the closure.

If the government ships provided reliable low cost service, this situation would not be a problem. The vessels, however, do not operate on a reliable schedule and are currently idle.

3. State Owned Enterprises in the Marshall Islands

48. There are a substantial number of State Owned Enterprises (SOEs) in RMI. (Although in this regard, state ownership is not as extensive in RMI as in some other economies in the Pacific region.) A feature of most of the SOEs in RMI is that they are in poor financial health and offer substandard service. Each of the SOEs has its own board of directors with the large majority of directors being from the public sector so that commercially oriented oversight is completely absent. While some SOEs are operated under management contract, the majority of the contracts are awarded on a non-competitive bid basis. In the vitally important area of telecommunications, in which the government is the majority shareholder, the NTA has a monopoly of landline, cellular, and Internet services. A brief description of each entity follows.

49. *Marshall's Energy Company (MEC)* is a wholly owned government entity. MEC activities include electrical power generation on the Majuro, Jaluit, and Wotje Atolls. MEC is one of the few SOEs that is profitable and no longer receives government subsidies. The board of directors is comprised mostly of government officials and two private sector representatives. The price of power, however, is high (see table 3). Furthermore, MEC has a waiver from all duty and taxes on imports of diesel fuel, which gives it a substantial competitive advantage over Exxon, the commercial importer of fuel. This advantage appears to allow cross subsidization of power generation – the profits on diesel imports are

Table 3. Comparative Utility Costs

COUNTRY	ELECTRICITY ^a (US\$/KWH)	TELEPHONE CALL TO US ^b (US\$/MINUTE)
Fiji	0.16	1.10
Micronesia	0.10 – 0.16	2.00
Kiribati	0.24	2.10
Marshall Isl.	0.16	2.00
Palau	0.10	1.50
Samoa	0.18	1.35
Solomon Isl.	0.16	1.10
Tonga	0.31	1.20
Tuvalu ^c	0.37	4.00 ^d
Vanuatu	0.26	1.50
Australia	~0.06	~0.17

Notes: ^a Average commercial tariff, 1999

^b Representative, converted to US\$ using the ave. exchange rate for 2001. Source: Regulatory framework and transaction models for private participation in infrastructure in Pacific Islands countries." Draft report prepared for the World Bank by Meritec Ltd., New Zealand.

^c Source: ADB, Tuvalu 1997 Economic Report

^d Rate is for Rest of World. It is 2.50 to Australia. Source: ADB, Tuvalu 2002 Economic & Public Sector Review

used to reduce the charge for electricity. To the extent that diesel is used for private sector activity, the cross subsidization is a tax on private sector development.

50. *Marshall's Alternative Energy Company, Inc. (MAEC)* MAEC was established to bring solar energy systems to the outer islands of the Marshall Islands. Through a French government grant, MAEC installed solar systems on the Namdrik atoll. At present MAEC is not operating and is under the direct supervision of the Ministry of R&D. There is discussion of MAEC merging with MEC in the near future. The Board of Directors is comprised of government officials.

51. *National Telecommunications Authority, Inc. (NTA.)* The government owns the majority of the shares of NTA, the rest are held by domestic investors. NTA provides telephone, Internet, and cellular services on both the Majuro and Kwajalien (Ebeye) atolls. The Board of Directors is comprised mostly of domestic stockholders, with the Ministry of Finance representing the government with its majority shares in NTA. Overall, telecommunications services are expensive and unreliable. NTA has a statutory monopoly on all provided services until 2012.

52. *Majuro Water & Sewer Company (MWSC.)* MWSC is a wholly owned government entity. MWSC activities include fresh and salt water distribution and sewer services throughout the Majuro atoll. They also maintain the main reservoirs at the airport. (ADB has heavily funded MWSC infrastructure requirements.) MWSC runs at a substantial loss and depends on the government for financial assistance. In an effort to stabilize MWSC, MEC took over the management of the water company but it continues to lose money. The Board of Directors is comprised mostly of government officials.

53. *Air Marshall Islands, Inc. (AMI.)* AMI is a wholly owned government company. AMI operates two 18 seat Dornier 228, an 8 seat Islander, and a 36 seat leased Dash 8 aircraft. The financial position of AMI is precarious – it has never made an operating profit and depends heavily on government subsidies. The majority of AMI's board are government Ministers with one private sector representative. Its service was widely reported to be very unreliable, a particular problem for the promotion of tourism on the outer atolls where there is supposedly only weekly service. In addition, there were reports from representatives of

the tourist industry that the non-arrival of scheduled flights stranded customers on outer islands for days at a time, which has harmed the development of tourism.

54. *Marshall Islands Shipping Corporation (MISC.)* MISC is a non-functioning wholly-owned government entity. The initial purpose of the corporation was to transfer all government ships and shipping functions of the Ministry of Transportation & Communications to MISC. For political reasons, this arrangement never materialized, but rather individual ships were contracted out to different private sector companies.

55. *Tobolar Processing Authority, Inc.* Tobolar is a wholly-owned government entity responsible for copra purchasing and processing. The Board of Directors is comprised of three government officials and two private sector representatives. Management is contracted out to a private company through a non-competitive bid contract. Copra is virtually the only cash crop produced in the Marshall Islands and for many of the outlying island communities, it is the only source of cash revenue from agricultural production. Tobolar purchases copra at a predetermined price that is substantially above world price levels⁶. It is then compensated for the losses that it makes – the approximate subsidy is equivalent to over half the price that it pays for copra. Tobolar is also the only company that can legally export copra. The scheme, therefore, enshrines inefficient practices and at the same time excludes any possibility of more efficient firms entering the copra business.

56. The government uses copra purchases as a means of redistributing income to the outer islands. In practice, however, the way in which the scheme is managed significantly reduces its effectiveness as a means of income redistribution. In addition, it violates principles of efficient subsidies and business practices because:

- The government budget is under pressure and when there are insufficient funds purchases are reduced. The more efficient copra production becomes, the less the government can afford to buy. In practice, this situation is handled by a scaling back of purchases, which effectively reduces efficiency incentives.

⁶ The largest producer of copra is the Philippines, which dominates world markets. Both an oversupply of copra and competition from other vegetable oils has resulted in substantial price declines over the past several years.

- The manner in which transport charges are factored into the price, the highest price for copra is paid in Majuro, where incomes are generally higher than they are elsewhere.
- There is not a set schedule for government boats to visit the islands to purchase copra since island shipping is so unreliable. Private operators, who go to buy copra, therefore risk finding that a government boat has preceded them, reducing incentives for private ship operators that are more efficient. At the same time, the incentives for the outer islanders to increase productivity are substantially reduced by the uncertainty regarding when the ships will arrive. Copra producers are part of the private sector – in many atolls it is the only private sector activity that exists. In addition, the perverse incentives provided by the copra scheme harms entrepreneurial activity more broadly because it undermines the private sector ethos of rewarding efficient production of a product that is in demand.

57. There is an effort to engage in different revenue generating schemes to help make Tobolar profitable that include making soap, producing edible oil, and eventually selling processed oil suitable for diesel motors. However, the ongoing subsidy reduces the incentive to search for viable uses of coconut oil. The scheme appears unsustainable in the longer run without a substantial further injection of government resources or basic reform to put a smaller scheme on a commercial footing and find alternative ways of subsidizing the outer islands.

58. *Majuro Resorts, Inc. (MRI)* MRI is a wholly owned government entity, but management is contracted out to a private company. Outrigger Resorts & Hotels of Honolulu, Hawaii currently holds the management contract. The average occupancy rate of the hotel is between 40 and 50 percent. Although, MRI is operating a positive cash flow, and is less than 10 years old, it now requires significant expenditure on maintenance that will necessitate an injection of cash from the government. The Board of Directors is comprised of government senators and one private sector representative.

59. *Majuro Dry-dock & Shipyards, Inc. (MDSI)* The government wholly owns MDSI, but management is contracted out to a private company on a non-competitive bid basis. MDSI's main activities are ship repairs. Their facilities include a submersible dry dock

capable of lifting an average size long line fishing boat. The board consists primarily of government officials and the company is running at a loss.

60. *Marshall Islands Development Bank (MIDB.)* The MIDB is a wholly owned government bank. The bank was set up to help finance key development in the tourism, fisheries, and manufacturing sectors. Contrary to its intended purpose, most of the loans made by the bank are consumer loans. Additionally, MIDB owns 35 percent of the stock in Bank of Marshall Islands, a private chartered bank. The Board of Directors is comprised mostly of government officials and one private sector representative. MIDB is discussed in greater length in the financial sector chapter.

61. *Marshall Islands Ports Authority (MIPA.)* MIPA is a wholly owned and operated government entity. MIPA, as the name implies, deals with all port activities in the Marshall Islands. The main activity is piloting services. The Board of Directors is comprised mostly of government officials and some private sector representatives. There have been substantial complaints regarding the very high salaries paid by the MIPA.

62. *Marshall Islands Airports Authority (MIAA.)* MIAA is a wholly owned and operated government entity. MIAA operates and manages the international airport at Majuro. The Board of Directors is comprised of government officials and some private sector representatives.

63. *Majuro Fish Base.* Through a Japanese grant, the government built a fish base to handle long liners⁷. At present, the government leases the facility to a Taiwanese firm.

64. *Majuro Fish Market.* Through a Japanese grant, the government built another fish base to handle domestic fishing vessels that provide fish for resale in the local fish market. The facility is jointly managed by MIMRA (Marshall Islands Marine Resource Authority, the body responsible for managing Marshall Islands fishing resources and licensing) and by Japanese fisheries experts, funded by the Japanese government. Currently, they operate a fleet of vessels that travel inter-island to collect reef fish from the various fishermen as well

⁷ The long liners calling port bring in yellow fin tuna for the Japanese sashimi market

as provide transportation of the fish collected at their outlet fish bases in the Arno, Namu, Alinglalap and Likiep Atolls.

65. *Laura Farms.* In the early 1980's, the government established a farm at Laura Village located at the other end of the Majuro atoll. The farm is managed and operated by agricultural specialists funded through a Taiwanese government technical assistance grant. The farm provides technical assistance to local farmers in Laura. They also grow a variety of vegetable and fruits for resale to the domestic market. The Laura Farm also took operational control of two other government assets at Laura village, the poultry farm, which produces eggs, and the breadfruit chip factory, which is currently non-functioning.

66. *Other State Businesses and Ownership:*

- The government owns a total of three inter-island ships, three landing crafts, and one fuel ship. A private company on a contractual basis operates only one government ship. The ships were to be transferred to the Marshall Islands Shipping Corporation, but for various reasons, the transfer never materialized.
- The Ministry of Health manages Majuro Hospital. At one time, Mercy International, an international non-profit organization, successfully ran the hospital under a management contract and was widely reported to have provided excellent service at a lower cost per patient than currently is the case. The contract, however, was not renewed after it expired.
- The Ministry of Internal Affairs operates a radio AM station (V7AB.)
- The government owns five long-line fishing boats that are no longer operating as long liners. The boats are in the hands of various government ministries and private companies.
- The Majuro Atoll local government operates a garbage collection service. There have been widespread complaints about its service and a tour ship company has suspended visits to RMI because of unsightly garbage.

4. Governance of State Owned Enterprises

67. The majority of the entities described above are completely dependent on the government, not only for capital funding but for operating funds as well. A further problem is that the financial accounts of most of the SOEs are outdated and of poor quality, making assessing their financial position difficult. Most of the state owned enterprises continue to lose money and most provide expensive unreliable services to the public. Often they are little more than employment agencies and operate with little regard for efficiency and profitability criteria. In addition, when government puts the running of SOEs in private hands, the contracts do not appear to be on a competitive bid basis and it is difficult to obtain a clear picture of the financial relationships involved. Since RMI is a small economy, obtaining competition in bids is probably difficult, given the limited number of companies that might have the capability to run government enterprises. More clearly defined operating and efficiency standards, however, appear to be needed and this report recommends that ADB provide the RMI government with assistance in developing and implementing these standards.

68. Furthermore, the administration of SOEs is diffuse - different ministries and statutory government agencies have operational control over of various SOEs often with conflicting plans of actions and priorities. Centralizing the oversight of the SOEs might provide a mechanism by which the government can improve efficiencies and initiate contracting out or privatization efforts where appropriate.

69. Government employees and ministers dominate the Boards of Directors of the state owned enterprises. This arrangement does not provide the enterprises with impartial oversight, nor does it provide commercial expertise and guidance to the enterprises. Furthermore, there is no prohibition on directors having interests in companies that administer other SOEs. A code of conduct for board members is urgently required. The appointments should come from the chamber of commerce and NGO's that have a direct interest in seeing services improve rather than naming individuals that may not represent the collective interests of the private sector.

70. Although, a private company currently manages the copra processing plant, the nature of the copra business makes it impossible for the company to show a profit and it will continue

to require heavy government support. There is strong political pressure to maintain the government subsidy of the copra price at levels significantly above world copra prices. In the long run, however, the scheme contains the seeds of its own downfall. In all cases around the world where production subsidies have been implemented, they have proved to be a drain on the budget that ultimately becomes unsustainable. In addition, by de-linking supply and demand for the product being subsidized, they completely undermine market forces. The RMI government will, therefore, have to face the problem of the copra subsidy at some point, and the sooner they do, the less wrenching will be the solution. While designing an alternative is beyond the scope of this paper, any solution should incorporate replacing the guaranteed price with direct grants, and privatizing copra purchasing.

71. The best run government SOE is MEC, the electricity company, both in terms of operating efficiencies and financial viability. It also obtains an implicit subsidy by not paying excise taxes on imports of diesel fuel, which is passed on to consumers in the form of lower electricity prices. Such subsidies are inefficient – as a general rule, all SOEs should be bound by the same operating criteria, tax obligations, and profitability standards as private sector companies. If this arrangement is absent, it is difficult or impossible to judge their performance.

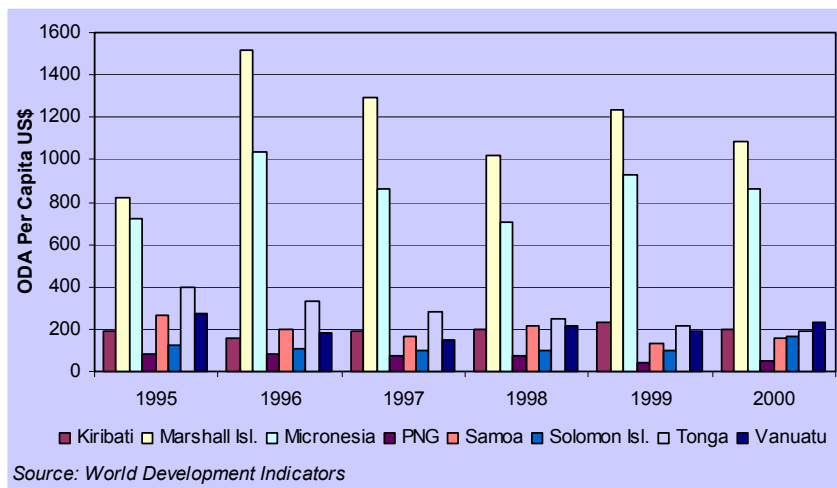
72. The guiding principle for SOE operation should not be protecting the financial position of SOEs but rather ensuring that services are supplied as efficiently as possible at the lowest price. In terms of such goals, subsidies to SOEs are inimical and reduce incentives to operate efficiently.

73. As a first step in achieving financial viability, the government needs a comprehensive plan regarding the future of each of SOE in RMI including the possibilities of contracting out services provided by the government such as hospital services and garbage collection. The PSU attempted to do this, but fell short in implementing a policy matrix for privatizing SOEs. This initiative needs to be revived.

5. The Use of Aid Payments

74. RMI has the highest level of development assistance in the Pacific region, which already has the highest level of aid per capita in the world. The major source of aid is payments under the

Figure 5. Comparative Per Capita Official Development Assistance



US Compact. Aid amounts to the equivalent of about 35 per cent of GDP. It is striking that the very high levels of aid have not resulted in any growth in the economy over the past 15 years and that in spite of the aid, per capita GDP has declined. Critics point out that in RMI aid has been used inefficiently, a conclusion with which it is hard to disagree. Aid payments go primarily to general government budget support, rather than to making the RMI economy more receptive to growth. Furthermore, since the bulk of government expenditure goes to salaries at levels that are said to be some 30 per cent higher than their private sector equivalents, the effect of Compact payments is to crowd out the private sector⁸.

⁸ The mission was unable to obtain precise wage and salary scales comparing pay in the public sector with that in the private sector. However, numerous interviews indicated that public sector employment paid better and offered almost complete job security regardless of performance.

C. Policy Recommendations

75. This section summarizes the policy recommendations that appear in the text above:

- The guiding principle of SOE operation is to supply services as efficiently and cheaply as possible.
- A comprehensive plan for the future of SOEs in the Marshall Islands is required. As a first step, placing all SOEs under one administrative umbrella is essential - it will eliminate the conflicting standards and operating criteria arising from a range of ministries being responsible for the SOEs.
- The government should investigate alternative income transfer methods to the copra price subsidy. The copra price subsidy's budgetary impact is unsustainable and it provides perverse incentives. In the long run it is damaging productivity and private sector development in the outer islands. This report accepts fully that the outer atolls require income transfers but the copra price subsidy is not the best instrument for doing this. It is the strong recommendation of this report that the government explore alternative income transfer methods and privatize copra buying completely.
- The management and oversight of the SOEs requires centralization to ensure consistent standards and operating procedures. A plan for each SOE is necessary to decide how to improve their operating efficiency and reduce the budgetary drain.
- Governance issues regarding board composition and functions are required to strengthen the oversight of SOEs. Standards of behavior, oversight functions, qualifications of board members and length of term all need to be examined within the context of corporate governance criteria.
- The government needs to develop standards and oversight for contracting SOE operation to private sector operators. This report recommends that ADB be approached for technical assistance.
- The government should abolish indirect subsidies, such as the diesel fuel exemption accorded to MEC, as part of a step to put SOEs on the same operational footing as private sector companies.

IV. The Financial Market

Table 4. Interest Rates, Deposit Money Banks, 1996 – 1999

76. The Marshall Islands has severely underdeveloped financial markets. The ratio of private sector credit to GDP is about 30 percent, although the major portion is consumer credit. Private sector credit to businesses from the

	1996		1997		1998		1999	
	DEC	JUN	DEC	JUN	DEC	JUN	DEC	
	(PERCENT PER ANNUM)							
Deposit rates								
Savings accounts ¹	2.8	2.8	2.8	2.8	1.4	2.9	2.4	
Time Deposits ²								
3 months	4.3	4.2	4.3	4.3	1.7	2.5	2.6	
6 months	4.7	4.8	5.0	4.9	2.0	3.2	2.8	
1 year and more	5.4	5.3	5.4	5.3	2.2	3.7	3.7	
Loan Rates ³								
Consumer Loans	18.0	18.0	18.0	16.0	9.6	19.0	15.9	
Commercial Loans	11.0	11.8	11.0	13.0	5.5	11.2	9.9	

¹ Average of rates offered by deposit money banks

² Average of minimum rates offered by deposit money banks

³ Average of maximum rate charged by deposit money banks

Source: Banking Commission Annual Reports

banking system is the equivalent of less than 5 percent, which puts the financial development of RMI among the lowest of developing countries.

A. Structure of the Financial System

77. There are only 3 banks in RMI:

- *The Bank of the Marshall Islands (BMI)*, which is by far the largest bank with about \$60 million in total assets. It has a 50 percent private sector ownership, with the other 50 percent being owned by the social security system (35 percent) and the Marshall Islands Development Bank (15 percent).
- *The Bank of Guam*, which has less than 20 percent in total assets. It is entirely foreign owned and does very little lending, being primarily an institution that takes in deposits and invests offshore in blue chip securities.
- *The Marshall Islands Development Bank* that was established to promote development lending but in practice undertakes substantial consumer lending to Marshallese.

1. The Bank of the Marshall Islands

78. The Bank of the Marshall Islands dominates the financial sector both from the perspective of taking deposits as well as in lending – it accounts for over 60 percent of all private sector credit. It has branches in Majuro and in Ebeye and operates monthly mobile banking services to the outer islands on government vessels, when they visit. The mobile banking service revolves around the purchase of copra – it provides the funds to buy the copra and accepts deposits from the sellers. (It is a particularly interesting example of taking banking to outlying areas and is worthy of consideration by other Pacific region countries.)

79. Of the \$60 million in total assets, about 20 percent is held in US government securities, and about 65 percent in loans. The majority of the loans are consumer loans, with repayments deducted from borrowers’ paychecks. BMI has only some \$5 million in lending to companies. The bank is highly profitable, earning a return on assets of about five percent (international norms for rates of return on assets for well run banks are closer to 2 percent,) and return on equity of 23 percent (much higher than most well run banks in other countries.) These rates of return are achieved with a relatively low rate of non-performing loans – in the region of 5 percent – although in practice actual losses are much lower. BMI keeps extensive credit information on its customers, which it shares with the other 2 banks. (An encouraging activity.)

80. BMI’s lending rates are in the region of 18 percent for consumer loans and 13.5 percent for commercial loans. Rates on lending against property are in the 15 percent per annum range. Time deposit rates are 4 to 5 percent for 12-month deposits. The bank is reluctant to lend for business purposes and only does so to the large companies on the island with which it has been dealing for an extended period. For businesses, it sometimes imposes countervailing deposit requirements that push effective interest rates even higher.

81. BMI has excess liquidity because of the absence of “bankable projects” and the high risk of lending to businesses in the absence of any reliable system of collateral. Though in some cases it does accept business assets as security, it is extremely difficult to execute against the security in the event of a default. In addition, it is impossible to determine whether the borrower owns assets that are being pledged, as there are no registries, even for automobiles. The Bank indicated that lease purchase arrangements would be broadly beneficial, but

because of inadequacies in the movable collateral framework, were not feasible. There is also no lending for agricultural or fishing activities for the same reasons.

82. There are a number of issues of concern:

- Officers of the bank are also in business on their own account. The President of BMI owns a wholesale company and a car dealership, among other businesses, and members of the business community who were interviewed, expressed concern at showing business plans to actual or potential competitors that happened to be bank officials. Although these observations may not be well founded, it is undeniable that this situation could have a dampening effect on the willingness of potential borrowers to approach the bank.
- Bank shareholders are planning to establish a holding company that will own the bank and at the same time other businesses. Unless there is a total separation between the banking business and the commercial entities, there is a strong danger that cross lending can become a recipe for financial problems as it has in other countries such as Chile, Mexico and Korea. In addition, there are potentially significant moral hazard issues - since BMI is the largest deposit taking institution in the Marshall Islands, there may be a view that the government cannot afford to have it fail.

2. Bank of Guam

83. The Bank of Guam has assets of approximately \$20 million. It has branches in Majuro and in Ebeye. It does little lending, however, and is not really a force in the RMI financial system for this reason. The problems with obtaining collateral against loans, either in the form of real estate or chattels, is the binding constraint governing its decision not to engage in lending.

3. The Marshall Islands Development Bank

84. The Marshall Islands Development Bank, was established in RMI to promote lending for economic development. In practice, however, much of its lending has been for consumer loans. It has been experiencing the usual problems of development banks elsewhere - it has a high proportion of non-performing loans that have resulted in severe liquidity problems.

There were unconfirmed reports that in the past it has experienced severe political pressures to lend to well-connected people regardless of creditworthiness and ability to repay. Even after an unconditional loan of \$5 million from the Republic of China, Taiwan, it is illiquid because of the severe portfolio problems that it is experiencing and as a result is currently not lending.

85. The recent proposal to supply businesses in RMI that are experiencing difficulties with credit of up to \$10 million in total will probably result in the financial position of the Development Bank deteriorating even further. Larger businesses in the Marshall Islands have been struggling with competition recently. However, the solution to this problem is greater efficiency or exit, not bailing out with subsidized loans.

B. Microcredit Issues

86. There is interest in initiating a microcredit facility in the Marshall Islands. Experience in countries where microcredit is active indicates that effective microcredit schemes require substantial expertise. Although recent analysis⁹ shows that microfinance institutions with assets as low as \$1 million can be profitable, they need to be run along strictly commercial lines. Furthermore, the same analysis indicates that subsidized microfinance institutions do not perform as well as those that operate with profit as the main objective. One of the most important factors in successful microcredit institutions is loan processing and follow up. These procedures, however, are

Box 1. Promoting Microfinance: The Multilateral Investment Fund

The Multilateral Investment Fund (the MIF), a fund attached to the InterAmerican Development Bank, has directly supported microfinance institutions in Latin America and the Caribbean and the process has had a profound impact on the development of microfinance. It has been involved in over 50 projects to promote sound, efficient micro-financing practices. This microcredit program has been both innovative and successful. The MIF has had a history of identifying microcredit institutions that have the potential for success and providing them with support to ensure that their potential is fulfilled. So good has the MIF been at the activity that it can justly claim to have shaped microfinance in the region and beyond. In several countries, commercial for-profit financial institutions have begun lending to informal entrepreneurs, which implies that the mandate for MIF projects to attain sustainability has been achieved.

⁹ Holden, Paul, Sarah Holden and Jennifer Sobotka, Microcredit Institutions and Financial Markets, The Multilateral Investment Fund, Washington, DC 2003

costly to implement and it necessitates charging real interest rates of around 30 percent – institutions that charge less than this are generally not successful. But, in RMI, the usury laws impose a ceiling on lending charges, an effective interest rate of 24 percent per year, too low to allow any microfinance institution to be sustainable.

C. Offshore Banking Issues & the Ship Registry

87. Following September 11th and the heightened concern, worldwide, regarding money laundering and the security concerns associated with banking havens, RMI was one of the offshore centers that was placed on the Money Laundering Blacklist by the US Treasury. This step was taken, according to RMI officials, not because there was evidence that RMI was actually being used for such purposes but rather because banking legislation did not render money laundering illegal. Following changes in banking legislation, the US Treasury has removed the Marshall Islands from the Blacklist.

88. The ship registry, the Trust Company of the Marshall Islands (TCMI), is an important source of service income. In terms of the Compact Agreement, vessels registered in the Marshall Islands are treated as if they are US registered vessels and as a result, many large US shipping companies use the Marshall Islands for registering their ships. The Marshall Islands registry is one of the 10 largest in the world and is ISO certified. TCMI is a wholly owned subsidiary of a US parent company. It also registers companies and operation of the two registries is linked because only RMI companies can register vessels. TCMI is a joint venture between the US owners and the RMI government in terms of which TCMI runs the shipping and companies register and pays about one quarter of its operating revenue to the government.

89. Although the registries are run efficiently and in international terms, competitively, TCMI faces two problems that hinder its effective operation. First, communication charges, both for telecommunications and Internet services are high and inefficient. The lack of a broadband Internet connection as well as the high cost of telephone calls raises its costs substantially. Second, there is difficulty in obtaining information on commercial law, which is especially important for the company registry business. (This issue is discussed at greater length in the chapter on institutional development.)

D. Conclusions & Policy Recommendations

90. There is substantial liquidity within the banking system of RMI yet businesses are short of financing. In essence, the only people able to obtain credit in the Marshall Islands are business owners with substantial assets and employees with regular paychecks, primarily those working for the government. As a result, the financial system is not financing business or development. The banks are either illiquid because of portfolio problems (the Marshall Islands Development Bank) highly risk averse and not willing to lend (the Bank of Guam,) or flush with liquidity but also cautious regarding lending in the high risk environment resulting from depressed business conditions and inability to secure loans against collateral (the Bank of the Marshall Islands.) The latter concern is warranted – the parlous state of the portfolio of the Development Bank of the Marshall Islands is an indication of the default rates that occur when sanctions against non-repayment of loans are not effective.

91. Many observers have pointed out that the problems with land tenure inhibit financial market development in RMI. They are correct. Lending against property constitutes a major portion of loans in all well-developed financial markets. An ADB technical assistance is underway as a first step toward reforming the land system. One result will be that eventually land will be useful as collateral against loans. This process, however, is likely to take many years. In the interim, other steps are necessary to promote financial market development, the most important of which is secured transactions reform. No significant reform of the financial sector in the Marshall Islands will be possible until the collateral framework for lending is addressed. The issues involved in creating an effective system of secured transactions that allows property to be pledged as security against loans is discussed in detail in the following chapter on institutions in RMI.

92. Other issues also warrant attention. There are potential regulatory issues with the Bank of the Marshall Islands connected with its intention to establish a holding company that will also own businesses. In other countries, similar structures have led to banks experiencing financial difficulties and modern regulatory practice insists on a separation of ownership between banks and their customers. Since there are substantial moral hazard issues

associated with BMI being the largest deposit taking institution on the island, the proposed new holding company has significant bank regulation implications that should be addressed.

93. Usury laws also need to be addressed if any sustainable microcredit institution is to be established.

V. Institutions & Private Sector Development

94. Ultimately, private sector activity in RMI or elsewhere is driven by the environment in which it operates. That environment is determined by the incentives and institutions that business people face which in turn are determined by the institutions that direct and impact private sector activity and the transactions costs imposed on their businesses. Important elements include:

- The institutions that provide the basis for private sector activity such as the legal system, the financial system, and infrastructure provision.
- Governance and political stability.
- Within the legal system: the viability of property rights and contracting within that system, and the dispute resolving mechanisms.
- Within the financial system: the ability of businesspeople to raise capital.

95. In the end, factors such as fisheries endowments, education levels, macro stability, and savings rates have little impact *in themselves* if the underlying institutional framework is missing.

96. Institutions reduce uncertainty in life by providing a structure in which individuals and organizations can operate. They achieve this end by defining and limiting the set of choices that are available to individuals. The definitions and limitations are devised to shape human interaction. They are the framework within which human interaction takes place - the “Rules of the Game.” Institutions interact with the economy through the impact they have on the costs of exchange and production – they determine the transaction and production costs for business entities – and when it is costly to transact, institutions are particularly important. They combine with the standard constraints of economic theory to establish the opportunities for business entities. Organizations are then created to take advantage of those opportunities. The state, however, has a powerful effect upon the incentives faced by the private sector especially when it attempts to modify behavior. It can end up creating

perverse incentives for organizations and increasing transaction costs. For example, if laws and regulations require useless inspections, or if there are contradictory and complicated compliance rules, or if taxes are high or arbitrary. Faced with this situation the private sector will modify how it behaves in ways that reduce productivity or not undertake certain activities at all.

97. In the Marshall Islands, institutions such as the legal and financial system are weak and fail to provide the foundations for private sector activity that are fundamental to private sector growth. In addition, transactions cost are high and there are many barriers to entry for small businesses and little benefit from being formal. The private sector cannot prosper in an environment that does not provide capital and financing for entrepreneurial activity. The remainder of this chapter examines these issues in more detail.

A. Land Issues

98. A great deal has been written about land issues in the Marshall Islands. A large proportion of land is held under communal and customary title. Foreigners may not own land, and frequently the viability of land leases has been questioned. Native-born Marshallese are allowed to own alienated land, but the validity of such titles is often in question and the subject of legal challenges that result in lengthy and expensive court proceedings. It also appears that corporate entities cannot own land, so that lenders such as banks cannot repossess property in the event of default.

1. Benefits of Secure Land Tenure

99. In merely physical terms, most land is used as an input into agricultural production. Agriculture, in many developing countries including those of the Pacific region, continues to be a key sector that provides the mainstay of economic sustenance for the majority of the people. Importantly, the rights enjoyed by those using the land will have an impact on the welfare of the rural population, the amount of output obtained, the level of investment undertaken, the scope of rural-urban migration, and the emergence, or not, of a vibrant off-farm economy.

100. The impact of giving people property rights to the land they cultivate is demonstrated most clearly by the case of China. Introduction of more secure property rights has led to impressive output gains and property rights are successively strengthened to facilitate investment and greater transactions in markets. In other words, rural households are less inclined to make investments in land that they do not own securely. In addition, the ability to use land as collateral in credit markets is usually a pre-condition for being able to obtain credit that can then be invested in the rural non-farm economy. Secure land rights are also critical for the ability to exchange land. In a broader context, property rights to land and the associated ability to trade land, provides a pre-condition for the emergence of financial markets. In all developed economies, mortgages, and other sources of credit that depend on land as collateral, are the paramount sources of credit. This situation would not be possible without well-defined, secure, and transferable rights to land.

101. Secure ownership and the ability to exchange land are critical for the investment climate for small entrepreneurs, in addition to being a pre-condition for the emergence of financial markets. It is for this reason that countries where property rights to land are not secure have much lower rates of investment. In most developed countries, the bulk of small businesses are started using loans that are backed by land. Property rights are no less important for the welfare of the poor. Indeed, the lack of formalized property rights prevents poor people from turning their latent assets into live capital – one reason why the entrepreneurial spirit that is so visible in virtually the entire developing world is not translated into a more inclusive pattern of growth¹⁰. Several empirical studies have related land registration to improved productivity through access to capital¹¹.

¹⁰ See de Soto, H. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, New York, Basic Books, 2000.

¹¹ See Byamugisha, F. *The Effects of Land Registration on Financial Development and Economic Growth*, Mimeo, Land Thematic Group, The World Bank, Washington D.C. 1998.

2. Special Problems of Land

102. It is often claimed that land holds a special place in the lives of the peoples of the Pacific, a role somewhat different than that found in other cultures¹². In addition to its function as the basis for subsistence, it has functions of power and status, spirituality, and cultural identity. It cannot be alienated. In truth, land holds a special place in almost all societies of the world¹³. What differs is the nature of tenure. The Pacific Island countries have encountered difficulties with land because traditional systems have run headlong into modern ones. Land conflicts are often an expression of political nationhood versus tribal organization. Nationhood implies delegating certain responsibilities to the state over communal and individual preferences. Achieving development justifies government primacy in social and economic infrastructure, and one part of that is land management – land reform.

103. Good land tenure systems are an equally necessary foundation for a growing private sector in the Pacific Island countries¹⁴ and the Marshall Islands is no exception. An ADB technical assistance project is about to begin that will start the process of land reform. The challenge is to find ways to integrate the communal/traditional land tenure system into the economy in ways that are compatible with both tradition and modern (liberal) economic practices. It is hard enough to draft a good property law, but it is even more difficult to create local land registries, local cadastre offices, and local court systems that serve all the citizens. In addition, there is the difficulty of finding the professional skills needed for mortgaging, conveyancing, surveying, property valuation, and other institutional services that form part of a land management system. All these factors have to be in place before a land market can be expected to play a full role in the development of the private sector and the economy.

¹² See, for example, S. Boydell, *Land Tenure and Land Conflict in the South Pacific*, Report for the Food and Agriculture Organization, September 2001.

¹³ Even in developed market economies, one does not have to question commercial farmers too deeply to reveal deeply-held spiritual views of stewardship, and farmer as caretaker, of the land.

¹⁴ Land tenure is defined as the rules of possession, use, and conveyance of land.

3. Land Tenure & Financial Market Development

104. One of the often unacknowledged potential benefits of secure property rights in land is the impact that it has on financial markets and the ability of potential entrepreneurs to mobilize their wealth to finance business. Since the major portion of the wealth of Marshall Islanders lies in their property, the fact that they cannot use it as security to finance improvements puts them at a significant disadvantage. As the chapter on the financial sector explains, interest rates for borrowing against property are extremely high, reflecting the low value of land as security.

105. This situation is a function of the fact that corporate “personas” cannot own land. It is ironic that a lease is more useful as security than a title. There are purchases and sales of land in RMI, especially on Majuro Atoll. But transactions take place between Marshallese only and all those interviewed indicated that under the current system, court challenges to ownership are common, costly, and time consuming. The forthcoming ADB technical assistance is an initial step at land reform in the Marshall Islands. It is intended to begin the work of establishing the infrastructure for a land-titling program. Although the details are still to be worked out, the program has the potential to be a valuable start to the process of defining land holdings more clearly.

4. Principles of Land Reform

106. There is no standard model for land reform in the Pacific region. For example, much criticism is misdirected toward individual freehold ownership¹⁵ and the fact that implementing a freehold system is difficult or impossible in the PDMCs. For improved land rights to assist private sector development in the Pacific, however, the fact that freehold ownership of land is not possible is not important. Much land in industrial countries is held outside freehold ownership and managed by leasing¹⁶. Leasing, cooperative ownership, and condominium tenure are alternatives. Rather, the problems in land tenure in RMI lie in:

¹⁵ The Heads of Government of the Pacific Islands Forum have discussed the issue at every annual meeting from 1995 to 2002.

¹⁶ Large portions of many western states of the US are owned by the government which leases different rights to those lands to different users. Much of the land under the city of London is inalienably owned by the

- Unclear ownership and unclear boundaries in large part because of lack of recording.
- Overlying restrictions on the transferability of land (mandated because of unclear ownership.)
- Unclear definition of the different land tenure rights.
- Weak (and unrecorded) dispute resolution practices.
- Problems of enforcement.

107. Program design for the RMI land reform program needs to incorporate key principles to gain the confidence and acceptance of customary landowners:

- The aims of the project must be widely publicized to ensure that the population is fully aware of the program.
- Existing accepted community organizations, such as councils of chiefs, should play a central role.
- National political institutions and parties should only provide a framework, facilitation, and recording.
- Robust dispute resolution and appeal mechanisms based on local practice, such as the customary reconciliation council, should be put in place.
- Steps should follow a defined process and agreements reached should be recorded and considered final¹⁷.
- The government should announce, at the outset, that constitutional protections on land will not be altered.
- The choice on whether to opt into the system or stay out should be optional for individual landholding groups.

British royal family; and much of the state of Hawaii cannot be alienated and is leased to the present users and developers.

¹⁷ In Vanuatu, people do not necessarily accept decisions as final, but expect to be able to renegotiate signed agreements. Publicity campaigns can assist in modifying this attitude and clarifying government's intent on land restructuring.

108. Under customary ownership, there is no one landlord/owner, nor often a well defined set of owners. There are frequently ill-defined boundaries between communal holdings and there are a variety of traditional ways to manage community land, many disputed within the family of owners. To deal with these problems, the steps in the land restructuring process might be undertaken in the following order:

- i. Identify rightful claimants to a roughly defined piece of land, through a defined and agreed to process, and record those claimants as common owners.
- ii. With local and adjacent landowners, define and record the boundaries to each plot of kinship land.
- iii. Put in place a formal family/clan governance structure agreed to and operated by the owners to manage that piece of land.

109. The steps are simple; the process is not and complications can be manifold. Critical issues that need to be addressed are identified below.

a) Issue 1: Recording/Registration

110. While it is possible to record land ownership under limited conditions in RMI, it is cumbersome and difficult. Registries and registration laws and regulations set the foundation for secure transactions and need to be established. Registration of land and leases may be optional at the choice of owners and renters. The market would then determine who did and who did not find it valuable to register. Modern notice-filing registry laws provide for inexpensive and more secured registration systems. Under notice-filing registry laws, the law provides for guaranteeing the filing of information as provided by the parties, and entering it into a secured database. Thus, the registry becomes less expensive to operate, and more secure. Such an approach narrows the duties and responsibilities on the registry so that the system is less expensive in terms of resource requirements yet still provides a more secure system for the filing itself. The possibility that the registry be administered by the private sector in a competitive manner (instead of the present public monopoly) could also be examined.

b) Issue 2: Transferability & Use of Land

111. Another factor providing market value lies is the ability to transfer a land right freely. In the RMI, there are restrictions on the transferability of land and land use. Complex and non-durable negotiations are necessary to obtain access to land outside urban areas and land held by custom owners cannot be mortgaged. Some restrictions may bring benefits to a country, such as when the law limits people from holding land they do not use. But arrangements that are more flexible need to be designed, and separating ownership rights from use rights would greatly facilitate a market in land-use.

c) Issue 3: Uncertainty of Land Tenure Rights

112. Property rights can only be granted by public law or by the community at large. To know, therefore, the qualities of a land right, people will turn to the law, either statutory or customary. In RMI, land rights are based in custom which gives rise to uncertainty about land use rights. Custom principles are often not publicly known to all interested parties because they are not written and recorded. This lack of publicity is a key difference between statutory law and custom – statutory law is forced to be consistent by the act of publication. But customs are not written down. By their unwritten nature, therefore, they can “change” depending on the circumstances. A party to an agreement cannot know:

- When actions of a community’s representative become binding on the community.
- When a leader can sign a valid lease.
- Whether the person claiming to represent the community is the accepted representative of the community.

d) Issue 4: The Cost of Disputes

113. Finally, land market value will be influenced by the costs of resolving land disputes. These costs include:

- Actual fees of the process.
- The time it takes to process.
- The certainty in predicting the outcome of a land dispute.

- The certainty of a legal resolution being enforced.

114. A land dispute procedure established by law needs to be clear and inexpensive. It must be comprehensive so that it covers all cases. If the upcoming technical assistance to reform land rights covers part of these issues, it will have made a valuable start to the reform of land rights in the Marshall Islands.

B. Secured Lending & Movable Property Rights

115. The Marshall Islands has no effective framework for secured lending against movable property for the following reasons.

- The law in terms of which a security interest in property can be created is inadequate.
- There is no way of registering a security interest in movable property, let alone ensuring that there are no prior claims on the assets being offered as security - there are no registries, even for automobiles.
- Repossessing in the event of default takes months or even years.

116. While banks do take some assets as security, they place little store in the value of such collateral and require a large multiple of the value of the loan. In essence, the secured transactions framework is non-existent in RMI, a factor that hinders financial market development and contributes to excluding Marshallese from the financial system.

117. In the next section, there is a brief description of the essential elements of a secured transactions system.

1. Essential Elements of a Secured Transactions Framework

118. The fundamental distinguishing trait of a secured lending system lies in granting priority to a lender or credit seller in collecting against some property of the debtor. Without such a security interest, a creditor is unsecured. Such a creditor has only a general claim against a debtor's property – a claim that gives that creditor no better right to payment than any other unsecured creditor. Since there is no bankruptcy law in RMI, if a company becomes insolvent, there is no effective means of closing it down and selling off its property.

A legal system that supports only unsecured lending will lead creditors to lend less to any given borrower, for shorter periods of time, and at higher interest rates, a situation that describes lending in the Marshall Islands. For a system of secured lending to work, it is not sufficient that property have value. There must be in place a legal system that permits the secured party – the lender – to recover and sell the property in a way that realizes as much of the market value of the property as possible.

119. The economic usefulness of a legal system for security interests will depend on how well that system fulfills certain key requirements:

- The law must provide for creating an enforceable security interest against all economically important property – both tangible and intangible.
- It must apply to all important transactions in which security interests are created.
- The cost of creating such a security interest must be low relative to the value of the property.
- Enforcing the security interest must be inexpensive relative to the value of the property.
- The law and the institutions that

The lending terms of Washington DC credit unions illustrate the effect of a good secured transactions framework. The credit unions of employees of the World Bank, the International Monetary Fund, or the Federal Reserve offer different loans at different terms depending on the collateral that the borrower offers. For example, they would offer a borrower without collateral a loan with an interest rate of about 12.5%, repayable in about 33 months, amounting to as much as 50% of the borrower's income. For a borrower offering movable property as collateral, these lenders would charge lower interest rates and offer longer repayment periods and larger loans relative to the borrower's income. For a borrower offering real estate as collateral, interest rates would drop even more, while repayment terms became longer and loans even larger relative to the borrower's income. Broadly, the more and better the collateral offered by the borrower, the lower the interest rate, the longer the time to repay, and the larger the loan relative to income. Overall, when borrowers offer better collateral to lenders, borrowers pay interest rates about 50% as high, have as much as 11 times more months to repay, and receive loans as much as 9 times greater relative to income. These changes in terms illustrate, unambiguously, the power of collateral. For exactly for the same borrower -- with the same income, the same credit record, the same loan committee and, often, the same credit officer – these institutions will lend more at lower rates of interest for a longer period of time if collateral is offered, than if it is not.

Box 2: The Power of Collateral

implement the law must allow the lender to determine before the loan is made, with certainty and at little cost relative to the value of the property, whether any other lender has a superior claim to the collateral.

- The secured lender must be protected from hidden claims of third parties, including secured and unsecured creditors, a trustee in bankruptcy, or some purchasers of the collateral.

120. Often the features that cause problems in a secured transactions framework have no obvious justification in public policy. And even where they do have a public policy objective, the means of achieving the objective (tax collection, or protection of workers, debtors, and tenants) can impose a high cost on the country's economy by reducing access to credit. In addition, and most importantly, it is possible to use other policy measures to achieve these worthy objectives without compromising a country's access to credit. To understand what is necessary for establishing a framework for secured transactions, it is essential to understand the four economically important stages of any system. Those stages are:

- *Creation.* The process by which the creditor establishes a security interest in a specific property (the collateral.)
- *Priority.* The process by which the lender establishes the priority of the security interest.
- *Publicity.* The process that makes public the priority of the security interest.
- *Enforcement.* The process by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy his claim.

121. Each of these stages must exist and be properly defined in a country before secured transactions can be undertaken. Such reform is needed urgently in RMI.

C. Commercial Codes

122. The commercial laws underlying private sector transactions in RMI are outdated and unsuited to modern business practices. Many of them date from the 1960s and 1970s and are based on US commercial codes from the 1950s. A particular problem is that there is no

bankruptcy code. There is a provision in terms of which companies can elect to close themselves down, but there is no law under which creditors can apply to the court for liquidation and sale of assets of companies that are unable to pay their debts. This situation has a pernicious effect on the provision of trade credit – one company allowing another to defer payment on goods supplied for a specified period. In addition, the winding down of companies that are unable to meet their financial obligations can take many years, putting both the assets of the company and the creditors into an effective limbo that ties up resources for extended periods.

123. A further problem is the haphazard codification of laws governing business transactions. Appendix A contains an annotated list of laws and regulations that govern business transactions in RMI as could best be ascertained. The list, however, might be incomplete because it is extremely difficult to obtain information on the laws that have actually been passed. At times, going through Parliamentary minutes is frequently the only way to obtain information on rules that apply to particular commercial transactions. Similarly, obtaining information on precedent from legal rulings is difficult and costly.

D. Foreign Investment Issues

1. Foreigner Work Permits

124. Companies reported difficulties and delays in obtaining permits for foreign workers. Like other Pacific region economies, RMI is critically short of skills of all types - one of the reasons for the low productivity in the region. Yet, it is difficult to obtain work permits for foreigners possessing such skills. There are requirements that any job vacancy must be advertised to ensure that there are no qualified Marshall Islanders available. In practice, this requirement results in substantial delays in filling positions. The policy has a perverse effect. It drives down overall productivity levels, thereby keeping salaries low which in turn encourages emigration of skilled Marshall Islanders. Reluctance to approve work permits for foreign workers is based on what is known as the “lump of labor fallacy,” namely that there is a limited amount of work to be divided among the workforce. By this fallacy, it follows that if a worker is brought in from outside, a local must lose a job. The reality is far

different, however. A skilled worker will raise productivity and create output and in so doing, jobs for the local population. Every country in the Pacific region should welcome any skilled foreigner with open arms. Rather than make it difficult for businesses to bring in skilled workers, RMI must simplify and expedite its approval processes.

2. Foreign Investment Procedures

125. Similarly, the fastest way to upgrade business practices is to learn them from foreign investors. Although the Marshall Islands has improved the laws governing foreign investment, there are still substantial administrative delays because applications are not processed speedily. The government has requested that FIAS assist in analyzing and evaluating foreign investment practices, a step that this report strongly endorses.

126. The government also has the power to grant special subsidies to foreign investors, the most important of which is a tax holiday (although this is limited to fishing, hotels and resort facilities, manufacturing, and agriculture). Both the tax holiday and the list of activities to which the incentives are applied are distortionary.

E. Policy Recommendations

127. Land reform has commenced, which this report strongly endorses. It is recommended, however, that as the reform proceeds, the necessary supporting legislation to allow for financial market development be passed.

128. This report recommends that work be initiated to reform the secured transactions framework in order to promote financial market development.

129. This report recommends that ADB assist the government of the Marshall Islands to codify the laws that apply to commercial transactions as a first step towards modernizing and updating its commercial code.

130. This report recommends that the commercial code, including provisions for bankruptcy, be reviewed and modernized.

131. This report recommends that restrictions on employment of foreign workers be removed and that delays in approving foreign investment applications be reviewed and reduced.

VI. Sector Issues

A. Tourism

132. Tourism is an obvious means of increasing both earnings from abroad as well as raising employment opportunities. Currently, however, the number of genuine tourists is very low – by some counts in the region of 1000 per year. There is a low awareness of RMI in the outside world, it is expensive to get to the

Marshall Islands, and Majuro is not an attractive destination because of the garbage and lack of facilities. Since going to the outer islands is also costly because of the high domestic airline charges, the travel costs associated with a trip to RMI

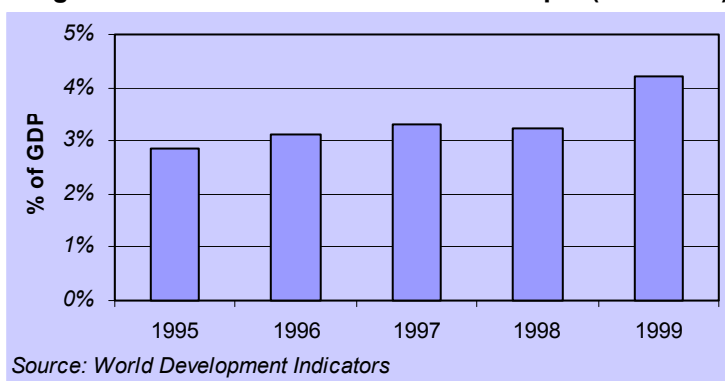
are high. Although there are wonderful resources in the outer islands, the tourist industry has to compete with many other destinations and the inconveniences and high costs are drawbacks to tourism growth. Nevertheless, there has been strong growth in the number of tourists, but from a very low base.

133. The Marshall Islands Visitors Authority is trying to promote tourism. Its current budget per genuine tourist implies an expenditure of about \$300 per person. A substantial portion of the expenditure, however, goes to paying salaries at MIVA so that the effective expenditure on promotion is far lower than the very high nominal amount suggests. As in

Table 5. Visitors by Purpose of Visit, 1999

PURPOSE OF VISIT	#
Business	2,047
Holiday/Vacation	1,093
Transit	556
Visiting Friends/Relative	462
Other	464
Not Stated	0
Total	4,622
<i>% Holiday</i>	<i>24%</i>

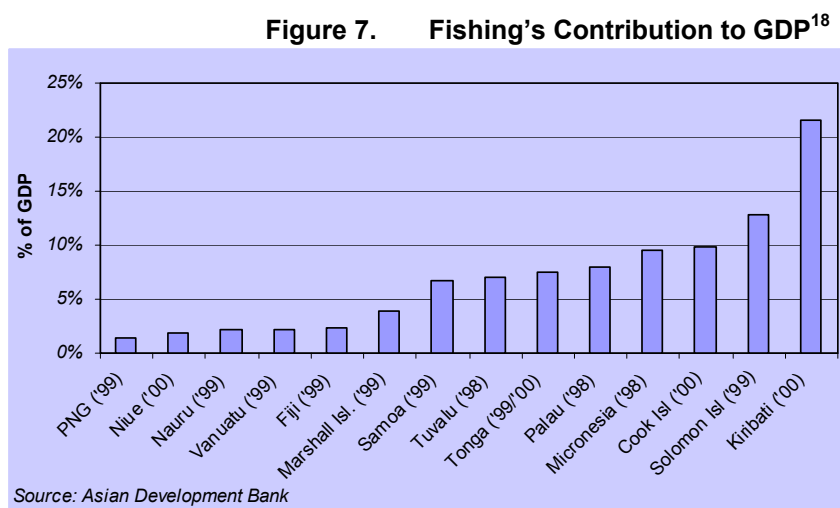
Figure 6. International Tourism Receipts (% of GDP)



Samoa, targeted expenditure in a small number of markets, with a reduction in personnel costs is probably the best way to achieve increases in tourism numbers.

B. Fishing

134. The Marshall Islands gains significant revenue from the licensing of foreign fishing vessels to catch fish in its economic zone (\$US 4.4 million.) Although there were complaints about the



failure to interdict vessels that were fishing illegally, the process appears to be working reasonably well.

Table 6. Land & Exclusive Economic Zone Areas for the Pacific Region

COUNTRY	LAND AREA	EXCLUSIVE ECONOMIC ZONE AREA
Marshall Islands	181 sq. km.	2 million sq. km.

Source: Asian Development Bank and Secretariat of the Pacific Community

135. In addition, the local economy generates significant jobs through the tuna loining plant, which employs approximately 300 people. The plant is owned by a US shipping company, and obtains most of its financing through bank loans that have been guaranteed by the Marshall Islands Marine Resource Authority (MIMRA).

136. The company has an abrogation from the provision of the labor laws and also has tax benefits. But, it is concerning that the commercial viability of the plant has yet to be established. After more than three years of operation, it is yet to make a profit and is substantially short of achieving projected levels of output. In spite of this situation,

¹⁸ Source: The Contribution of Fisheries to the Economies of Pacific Island Countries. ADB. 2002.

however, it is considering expanding. The main justification for the subsidy to the loining plant is that it generates significant employment. At the wages that it pays, however, it has difficulty maintaining a stable workforce – labor turnover is very high. Management estimated that some 2000 Marshallese had worked at the tuna facility.

C. Policy Recommendations

137. This report recommends:

- A review of tourist promotion policies, including the effectiveness of current expenditures.
- Narrower targeting, increased budgets for advertising, and reduction of personnel has the potential to increase the number of genuine tourists.
- Abolition of subsidies to investment, including any to the tuna loining plant to support further expansion.

VII. Conclusion

138. The conclusion of the PSA is that doing business in the Marshall Islands is difficult. Problems with property rights and the laws related to business transactions make arms length contracting almost impossible and finance very difficult to obtain. The prominent role of the state in the economy raises costs for business and crowds out employment and entrepreneurship. The impact of state intervention augments the negative effects of isolation, size, and vulnerability of the country, which are further compounded by a trade regime that is characterized by variable tariff rates and taxes on imports on which there are many exemptions. This situation has resulted in an atmosphere of tension and mistrust between government and the formal private sector.

139. At the same time, the institutions and incentives inherent in the current system put native born Marshallese at substantial disadvantage in doing business. The problem is not the result of discrimination or exclusion, but rather because the interaction between property rights on the one hand and the financial system on the other disbars most of the local population from even the possibility of mobilizing their wealth to finance business ventures. Furthermore, the incentives faced by Marshallese in the outer atolls, especially the government-sponsored copra purchasing scheme, do not encourage entrepreneurial activity. This exacerbates the incentives to migrate to the urban centers.

140. In the view of the authors, the time is ripe for a national debate regarding the role of the state, the role of business, and how reform should proceed.

Appendix A: RMI Commercial Laws

A. Business Corporations

141. *Corporate Administration – Title 52, Chapter 1 RMI Revised Code 1998.* Known as the “Corporate Administration Act.” An act establishing two registrars of Corporations: a Registrar of Corporations responsible for resident domestic and authorized foreign corporations delegating responsibility to the Attorney General’s Office and a Registrar of Corporations for non-resident corporations delegating responsibility to the Trust Company of the Marshall Islands.

142. *Bill No. 3, P.L. 2000-4: Amendment to the act, section 7.* Transfers the responsibility of issuing corporate charters from the Cabinet to the Registrar of Corporations. Fees for application of a charter is a \$250.00 initial fee and a \$100.00 annual renewal fee.

143. *Corporate Formation – Title 52, Chapter 2 RMI Revised Code 1998.* Known as the “Corporate Formations Act.” An act that provides regulations on establishing a corporation in RMI whether domestic or foreign.

144. *Corporate Operations – Title 52, Chapter 3 RMI Revised Code 1998.* Known as the “Corporate Operations Act.” An act that provides regulations on the set up and functions of the Board of Directors, Management, and Shareholders.

145. *Corporate Changes – Title 52, Chapter 4 RMI Revised Code 1998.* Known as the “Corporate Changes Act.” An act that provides regulations on mergers, consolidations, and dissolution of a corporation.

146. *Foreign Entities – Title 52, Chapter 5 RMI Revised Code 1998.* Known as the “Foreign Entities Act.” An act that provides regulations with respect to foreign entities and maritime entities registered as offshore companies in RMI.

147. *Domicile Transfer – Title 52, Chapter 6 RMI Revised Code 1998.* Known as the “Domicile Transfer Act.” An act that provides regulations for the transfer of domicile into and out of RMI.

B. Partnerships & Other Associations

148. *Cooperative Associations – Title 18, Chapter 7 RMI Revised Code 1998.* Known as the “Cooperative Act of 1993.” An act that provides the orderly marketing of certain products through the formation of cooperative associations in order to make the distribution of cooperative products between producer and consumer as direct as can be efficiently done.

149. *Partnerships – Title 53, Chapter 1 RMI Revised Code 1998.* Known as the “Partnership Act.” An act that provides regulations for the formation of partnerships and their operations.

150. *Limited Partnerships – Title 53, Chapter 2 RMI Revised Code 1998.* Known as the “Limited Partnerships Act.” An act that provides for the formation of a limited partnerships and their operations.

151. *Unincorporated Associations – Title 53, Chapter 3 RMI Revised Code 1998.* Known as the “Unincorporated Associations Act.” An act that provides an unincorporated association of a body of individuals acting together for the common purpose of enterprise without a corporate charter, mandated by its by-laws pertaining to its conduct and operation.

152. *Limited Liability Companies – Title 53, Chapter 4 RMI Revised Code 1998.* Known as the “Limited Liability Act of 1995.” An act that provides for the establishment of a limited liability company in RMI.

C. Foreign Investment

153. *Foreign Investment Business License – Title 10, Chapter 5 RMI Revised Code.* Known as the “Foreign Business License Act of 1990.” An act requiring any foreign person or entity desiring to operate a business in RMI to first obtain a foreign investment business license (FIBL.)

154. Bill No. 4 Public Law 2000-5 amends the Foreign Investment Business License Act. The amendment transfers the authority to grant and issue an FIBL from Cabinet to the Attorney General’s Office. The fee for such a license is \$250.00, which is valid for period of 25 years.¹⁹

155. *Investment Incentive Agreement – Title 10, Chapter 12 RMI Revised Code 1998.* Known as the “Investment Incentive Agreement (Implementation) Act of 1988.” The act provides for the extension of programs of the US Overseas Private Investment Corporation (OPIC) to US businesses, which invest in the Marshall Islands.

D. Trusts

156. *Trust – Title 50, Chapter 1 RMI Revised Code 1998.* Known as the “Trust Act of 1994.” An act to allow for the registration of trust in RMI.

157. *Trust Companies – Title 50 Chapter 2 RMI Revised Code 1998.* Known as the “Trust Companies Act of 1994.” An act to govern the establishment, operations, and licensing of trust companies in RMI.

158. *Trustee Licensing – Title 50 Chapter 3 RMI Revised Code 1998.* Known as the “Trustee Licensing Act of 1994.” An act to provide for the licensing of trustees in RMI.

¹⁹ After being granted a foreign business license, one must still file and pay the \$250.00 fee to incorporate, plus pay the fees for a business license for that particular local government jurisdiction. At a minimum a foreign investor must pay a total of \$500.00 in fees to the national government and depending on the local government business license fee structure, it could add another \$500.00 in fees. So it is not uncommon for a foreign investor starting up a new business in the RMI to pay in excess of \$1,000.00 initial fees. Afterwards, the foreign investor only has to pay \$100.00 renewal fee for incorporators and as high as high of \$500.00 business license fee to the local government in Majuro.

E. Banking

159. *Banking Regulation – Title 17, Chapter 1 RMI Revised Code 1998.* Known as the “Banking Act of 1987.” An act that establishes the Banking Commission to regulate all banking activities in RMI. No banking business shall be transacted in the Republic except by a corporation that is in possession of a valid license issued by the Banking Commissioner with the approval of the Cabinet authorizing the transaction of banking business in or from within RMI.

F. Business Regulations

160. *Building Permits – Title 10, Chapter 2 RMI Revised Code 1998.* Known as the “Planning and Zoning Act of 1987.” The act establishes the Planning Commission. Section 13 requires anyone or any business, before engaging in any construction activity, to first obtain a building permit from the Local Government Council’s Planning Commission for that particular jurisdiction. If the local government fails to appoint a commission, then the Minister responsible for planning may appoint the Government’s Chief Planner to perform all or any of the functions and duties conferred on the Planning Commission or the Local Government Council.

161. *Bulletins Boards and Price List – Title 20, Chapter 6 RMI Revised Code 1998.* Known as the “Bulletin Boards and Price Lists Act of 1976.” This law requires that ship owners erect a bulletin board onboard their ship showing the price of goods to be sold. Additionally, two copies of the price lists are required to be filed with the Secretary of Transportation.

162. *Consumer Protection – Title 20, Chapter 4 RMI Revised Code 1998.* Known as the “Consumer Protection Act.” Authorizes the Attorney General to investigate businesses engaging in any act or practice, which is unfair or deceptive to the consumer. The fine for such violations is \$10,000.

163. *Duty Free – Title 20, Chapter 5 RMI Revised Code 1998.* Known as the “Duty Free Concessions Act.” The Cabinet shall promulgate such rules and regulations as deemed necessary to carry out the provisions of this act. The duty free concession shall be publicly

solicited or advertised publicly for a duty free concession is granted. Only one company is known to have duty free status in RMI.

164. *Licensing of Copra Trade – Title 20, Chapter 1 RMI Revised Code 1998.* Known as the “Business Regulations Act.” No person, firm, or corporation shall purchase copra for export within the Marshall Islands unless the Cabinet issues a license for such trade. So far, Tobolar Processing Authority is the only firm licensed to export copra from the Marshall Islands. It is, therefore, a monopoly.

165. *Price Monitoring – Title 10, Chapter 11 RMI Revised Code 1998.* Known as the “Retail Price Monitoring Act of 1992.” The act establishes the Marshall Islands Price Monitoring Board to monitor retail prices charged in RMI and authorizes the Cabinet to promulgate regulations to enforce and implement this act.

166. *Sale of Goods – Title 23, Chapter 1 RMI Revised Code 1998.* Known as the “Sale of Goods Act of 1986.” An act regulating the sale of goods in RMI and enforcement of sale contracts.

167. *Securities and Investments – Title 18, Chapter 2 RMI Revised Code 1998.* Known as the “Securities and Investment Act.” It shall be unlawful for any person, directly or indirectly, to issue, sell, exchange, or transfer any security in RMI unless or until such security has been registered with the Registrar of Corporations.

168. *Unauthorized Copies of Recorded Materials – Title 20, Chapter 2 RMI Revised Code 1998.* Known as the “Unauthorized Copies of Recorded Materials Act of 1991.” An act to protect sound and audiovisual work from being copied without proper authorization of the original owners of such materials.

169. *Unfair Business Practices – Title 20, Chapter 3 RMI Revised Code 1998.* Known as the “Unfair Business Practices Act.” An act to monitor uncompetitive practices in RMI and ensure that there are no restrictions to trade.

170. *Usury – Title 20, Chapter 8 RMI Revised Code 1998.* Known as the “Usury Act of 1989.” An act that sets a cap on the annual interest rate of 24 percent whether it is received as interest, in money, goods or services.

G. Labor

Table 7. Comparative Labor Regulation/Conditions

171. *Labor Working Standards – Title 16, Chapter 5 RMI Revised Code 1998.* Known as the “Labor (Minimum Conditions) Inquiry Act of 1983.” An act that establishes a board of inquiry to investigate the working conditions of workers in RMI. The Cabinet appoints the board and is confirmed by the Nitijela by resolution.

COUNTRY	LEGISLATED MINIMUM WAGE (\$US/HR)	AVE. LENGTH OF WORK WEEK (HOURS)	PAID HOLIDAYS (DAYS/ YEAR)
Fiji	0.63 – 1.09	45	13
Micronesia	1.35	-	-
Kiribati	1.08 ^a	36	13
Marshall Islands	2.00	-	-
Palau	2.50	-	-
Samoa	0.45	40	15
Solomon Islands	0.30	40	11
Tonga	-	40	11
Vanuatu	0.71	40	14

^a Not Legislated

Source: Forum Secretariat: Foreign Investment Climate in Forum Countries, June 2001 and World Bank staff consultation

172. *Minimum Wage – Title 16,*

Chapter 4 RMI Revised Code 1998. Known as the “Minimum Wage Act of 1986.” The act sets the minimum wage at \$2.00 an hour. (Section 403 allows the Cabinet to grant exemptions to export-oriented businesses.)

173. *Nonresident Workers Health Certificates – Title 16, Chapter 3 RMI Revised Code 1998.* Known as the “Nonresident Worker’s Health Certificate Act.” An act that requires every nonresident worker, before entering RMI, to obtain a certificate of freedom of communicable diseases from their country of origin.

174. *Protection of Resident Workers – Title 16, Chapter 1 RMI Revised Code 1998.* Known as the “Protection of Resident Workers Act.” An act to regulate employment of foreign workers in RMI. Before any employment of a foreign worker, the employer must first advertise the job position to any qualified citizens of RMI. If such qualified RMI citizens are not available in RMI, then the Labor division may grant a permit for bringing the foreign worker for a fee of \$100.00. The permit is renewable, but under discretion of the Secretary of Foreign Affairs.

H. Land

175. *Real and Personal Property – Title 24, Chapter 1 RMI Revised Code 1998.* Known as the “Real and Personal Property Act.” An act that provides for judicial foreclosure of property, which give rights in personal property, including houses on land not owned individually or entirely by the party or parties purporting to give an interest in the house as security for the performance of any obligations.

176. *Real Property Instruments – Title 24, Chapter 2 RMI Revised Code 1998.* Known as the “Real Property Trust Instruments Act of 1987.” An act that creates a trust in real property to secure obligations.

177. *Real Property Mortgage – Title 24, Chapter 4 RMI Revised Code 1998.* Known as the “Real Property Mortgage Act of 1987.” An act that enables banks to secure leasehold interests as security for bank loans.

178. *Land Registration – Bill No. 28, Public Law 2001-26.* Known as the “Marshall Islands Development Land Registration Authority Act.” An act to provide for the registration of title interest of land in the Marshall Islands.

I. Judicial Review

179. *Arbitration – Title 30, Chapter 3 RMI Revised Code 1998.* Known as the “Arbitration Act of 1980.” An act to provide for dispute resolution of agreements and contracts.

J. Taxes

180. Copra Tax – Title 4, Chapter 3 RMI Revised Code 1998. Known as the “Copra Tax Act of 1992.” An act that requires Tobolar Copra Processing Authority to collect 8 percent on the value of all copra delivered to it from within RMI and remit the funds to the respective Local Government Council jurisdictions.

Table 8. RMI Import Duties

181. *Import Duties, Title 48, Chapter 1 RMI Revised Code 1998.* Known as the “Import Duties Act of 1989.” Bill No. 75 P.L. 2001-43 amended the act as follows: there shall be a uniform tax on all imports at the rate of 8 percent value (CIF) except for the *ad valorem* specific or unit taxes listed in the table.

PRODUCT	RATE
Foodstuffs	5% CIF
Gasoline	20% CIF
New Motor Vehicles ²⁰	15% CIF
Motor Vehicles ²¹	\$2,500.00 for new vehicles (\$1,500.00 for used vehicles)
Public Transportation	5% CIF
Cigarettes	\$.075 per pack of 20 rolls
Cigars	150% CIF
Other Tobacco	\$2.50 per 34.2 grams or 1.2oz
Beer	\$.25 per can or 12oz unit
Wine	\$2.50 per gallon
Spirits	\$10.00 per gallon
Mixed drinks	25% CIF
Carbonated Beverages	\$.00833 per 1oz
Non-Carbonated Beverages	5% of CIF

182. *Bill No. 83 P.L. 2002-52.* The bill repeals section 207 of the act in its entirety, which previously gave exemptions for all equipment, furniture, fixtures, materials, and supplies imported for the operation and maintenance of the manufacturing, tourism, and fishing sectors.

183. *Income Tax – Title 48, Chapter 1 RMI Revised Code 1998.* Known as the “Income Tax of 1989.” Section 103 Tax on Wages and Salaries: 8 percent is assessed on the first \$10,400.00 and 12 percent in excess of \$10,400.00. An exemption is allowed for those earning below \$5,200.00 at \$1,400.00 per year. Five percent is assessed on all wages and salaries received by US contractor personal on the U.S. military base at Kwajelien Atoll (USAKA). All other personnel at USAKA are exempted from taxation as provided under the provisions of the compact agreement between RMI and the USA.

²⁰ In the absent of proper documentation, values will be based on the Kelly’s Blue Book rates, provided that in no case the duty assessed is not less than \$1,500.00

²¹ Whose value cannot be determined in the Kelly’s Blue Book

184. *Section 109 Tax on Gross Revenue (GRT).* A tax is levied on gross receipts by every business activity. The first \$10,000.00 is levied at \$80.00 and thereafter 3 percent.

185. *Section 116 Tax on Immovable Property.* Three percent is levied on all gross income generated from leases and rentals from real property, buildings, and houses/apartments.

186. *Section 117 Tax on Non-Resident Income.* Ten percent is levied on all gross incomes earned by non-residents relating to any clients in the Marshall Islands.

187. *Section 153 Tax on Hotel and Resort Facilities.* Levies an 8 percent tax on room sales on a revenue sharing basis. Ministry of Finance collects 7 percent and the Marshall Islands Visitors Authority collects 1 percent of the total revenue collected.²²

188. *Section 121 Tax Incentives.* Any new incorporated or unincorporated business that invests a minimum investment of one million USD and/or provides employment and pays wages in excess of \$150,000.00 per annum to local Marshall Islands citizens shall be exempted from paying taxes on gross revenues for a period of five years. The exemptions may be applied only to the following:

- ✧ Off shore or deep-sea fishing.
- ✧ Manufacturing.
- ✧ Agriculture.
- ✧ Hotel and resort facilities.

189. *Local Government Tax and Fees – Title 4, Chapter 2 RMI Revised Code 1998.* Known as the “Local Government Tax and Fees Act of 1989.” Section 202 stipulates that the local government may make ordinances for the levying of taxes and fees for the area in its jurisdiction. Section 203 further stipulates that the local government to submit names of businesses to the national government at the end of each quarter beginning with the fiscal year.

190. *Nonresident Workers Fees – Title 16, Chapter 2 RMI Revised Code 1998.* Known as the “Nonresident Workers (Fee) Act of 1987.” An act requiring every employer of a

²² MIVA has never received its 1% since the amendment to the income tax act.

nonresident worker to pay to the Secretary of Finance a fee of quarter dollar (.25) for every hour of work performed by a nonresident worker for such employer payable on a quarterly basis.

191. *Social Security Tax – Title 49, Chapter 1 RMI Revised Code 1998.* Known as the “Social Security Act of 1990.” Section 129 of this act requires that every worker deduct 7 percent from their gross wages. Section 130 of this act requires the employer to match the 7 percent of every worker’s contribution to the fund.

192. *Health Fund Tax - Title 49, Chapter 2 RMI Revised Code 1998.* Known as the “Social Security Health Fund Act of 1991.” Section 213 of this act requires that every worker deduct 2.5 percent from their gross wages. Section 214 of this act requires the employer to match the 2.5 percent of every worker’s contribution to the fund.

193. *Tax Collections – Title 48, Chapter 3 RMI Revised Code 1998.* Known as the “Tax Collections Act.” An act to provide for the collection of taxes through tax liens and civil action for collection of unpaid taxes.