

Chapter 2

Economic Performance

Key Points

- the economic statistics show no real growth since independence
- the statistical operation needs to be strengthened
- the labor force is set to grow much faster than wage employment
- use of the US currency both simplifies and constrains economic policy
- combining sovereignty services¹⁵ with investment in areas of comparative economic advantage offers the best prospects for growth
- further improvements are required to the investment environment
- the need to be more competitive is inescapable
- weak and non-transparent systems of managing public finance persist
- strengthening of public financial management is essential for development
- government revenues need urgently to be put onto a sustainable basis
- imminent Compact re-negotiations provide a priceless chance to do that
- provided there is also a comprehensive reform of taxation and tax collection

¹⁵ Sovereignty services include strategic access/denial, fisheries licensing, seabed access, shipping register, postage stamps, etc. Sovereignty services are saleable as long as they do not encroach upon the sovereignty of another (bigger, donor) nation. See Footnote 35, below, on sale of passports, etc.

National Income (GDP)

Gross domestic product (GDP) is the most commonly used definition of national income. It is the estimated total value of all economic activity within the RMI, arrived at by summing the value added by each economic factor to its inputs as it converts them to outputs for sale or its own use. Estimates of GDP, like most economic data in the RMI, have to be treated with some caution because of acknowledged deficiencies in the coverage of statistical services. The RMI, like several other Pacific states, does not give sufficient priority to the production of timely and reliable economic and social statistics, handicapping efforts to improve financial and economic management. In particular, commercial activity is likely to be understated in the official data because of under-reporting, for whatever reason.

With that caveat in mind, the official data show 1999 total output (GDP) at just under \$97 million, close to the 1996 level in nominal terms, and 6–7% lower when adjusted for inflation. Total GDP has been flat—or within the estimating margin of error—in recent years. Estimated real GDP (that is, adjusted for price changes, using the Majuro retail price index¹⁶ as the deflator) had risen in the early 1990s as a result of increased fishing activity and Compact-funded expenditures, but fell back after 1995 as the tuna fishery contracted and fiscal problems forced a sharp reduction in government spending. Real GDP is now officially estimated to be at about its 1987–88 level; according to the 1999 census, employment is also at the same level as in 1988. If this does not accord with many people's impressions of real economic activity now compared with 13 years ago, it may indicate, as noted above, that GDP estimates are failing to capture a complete picture; on the other hand, the employment data provide powerful support for the no-growth proposition.

¹⁶ This price index is in need of re-basing on a new expenditure survey, but is the only officially maintained inflation indicator. Combining reservations about GDP and the retail price index makes discussion of real GDP a particularly hazardous exercise.

The composition of estimated GDP has changed very little over the last decade. Government services, not including the state-owned hotel, airline, and utilities, account for about one-third of economic activity. Trading and transportation together account for 20–25% of output (much affected by sharp rises and falls in the fortunes of Air Marshall Islands), and primary production and manufacturing together account for about 15%. Copra processing, being heavily subsidized, currently makes a negative contribution to total GDP. (See also in Chapter 8).

Estimated per capita GDP, widely used as an indicator of national prosperity, is now around \$1,900. In nominal terms, this is about 50% higher than in the mid-1980s, but adjusted for inflation, it is about the same level as 15 years ago. It would have been significantly lower¹⁷ if population growth during the last 10 years had not been relieved by emigration. Even given the caveat on GDP data coverage mentioned above, this is a sobering perspective on the impact of a decade of government-led “development” with the benefit of Compact funding.

Balance of Payments

The balance of payments (BoP) is a statement of the financial flows and change in financial assets and liabilities between the RMI and the rest of the world. It is made up of two main parts. First, the current account, where payments and receipts for imports and exports of goods and services are recorded—or, as is often the case, estimated—along with remittances and grants that do not have to be repaid. And second, the capital account, where financial flows that result in a future liability to repay—borrowings and investments, mainly—are recorded or estimated. By definition it must balance, that is to say, a surplus or deficit in the current account must be matched by an outflow or inflow in the capital account, or a rise or fall in the net financial assets of the RMI held abroad, or both.

¹⁷ Per capita GDP would have been 10–15% lower, depending on the net contribution to domestic output emigrants would have made had they stayed home.

The use of the US currency means that for the RMI, the most important economic mechanism—the nominal exchange rate¹⁸—is fixed, or at least is beyond the control or influence of the RMI, and the Government is relieved of this policy-making task. At the same time, the RMI is not in danger of running out of foreign currency reserves since it uses the reserves of the US economy. So the balance of payments does not need to be a policy target. But financial constraints still apply. The country's individual economic actors, notably the Government, can run out of money. They can use up their domestic and overseas financial savings, exhaust their bank credit lines and access to loan markets, and run out of saleable assets. The difference is that their individual financial problems—even a budget funding crisis for the Government such as is occurring at the start of FY2001—will not affect the exchange rate or the access of other RMI entities to overseas financial markets.

By the same token, a balance of payments problem in the RMI is self-limiting, though the process may be painful. If the total of export earnings and other receipts in the current account is not enough to pay for imports, money must be found in the capital account by borrowing or drawing on reserves. If and when that source of funds is exhausted, imports must be adjusted downwards to match domestic ability to pay for them. That "iron arithmetic" applies equally to individual enterprises, the Government, and the whole economy (see below, on the impact of Compact flows). In these circumstances, where trade-related financial flows in and out of the RMI's money supply are effectively outside the control of RMI authorities,¹⁹ fiscal

¹⁸ But note that the real exchange rate, which takes into account relative movements in domestic prices (inflation rates) between the RMI and its trading partners, and is a key determinant of competitiveness, is more within the RMI's control. The domestic inflation rate is affected by, *inter alia*, taxation, incomes policy and government expenditure. For example, a relatively high rate of domestic inflation in the RMI, on top of a strong US dollar, would make RMI-produced goods and services very expensive internationally, such as for tourists, crippling the RMI's efforts to be competitive. A strengthening US dollar probably requires nominal prices in the RMI to fall in order to maintain competitiveness. A weakening US dollar helps competitiveness so long as domestic inflation remains low. See Box 2.3 for an overview of currency issue.

¹⁹ See also Chapter 6: The Financial System, on the constraints on monetary policy, and Box 2.3: Using the US Currency.

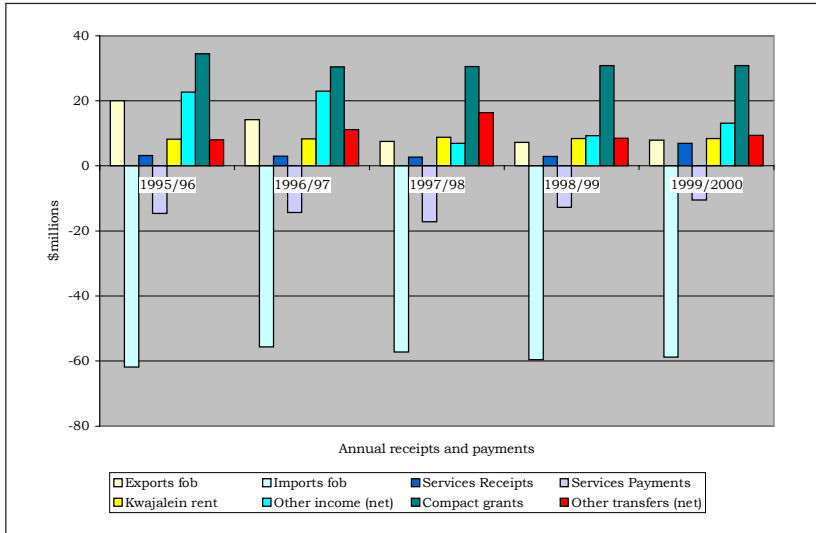
policy emerges clearly as the main—and when defined to include public service pay, the only—domestic policy tool available to the Government for stabilizing or stimulating the economy. This makes all the more important the reform of public financial management now being planned (see below), and the development of strong and effective fiscal policies (see Chapter 9).

As with the GDP data, the information available for BoP analysis is less than complete. It is clear from anecdotal evidence that substantial cross-border movements of US dollars take place as cash, and that many private investments in financial assets and property overseas are held by Marshallese who live at least part-time in the RMI and are active in the domestic economy. More specifically, there are difficulties with trade data in timing and classification of entries for imports and for re-exports of petroleum products (now a significant item because of fuel sales to tuna fishing and carrier vessels). Appendix A3.16 uses estimates prepared recently by the International Monetary Fund to provide an approximation of the magnitude of flows in the BoP over the last 5 years. Though this is the most up-to-date and systematic compilation available, all such estimates should be treated with caution until a stronger statistical operation is put in place. Figure 2 illustrates data from Table A3.16 to show the relative weights of the inflows and outflows in the BoP current account.

Subject to that caveat, points of interest in the balance of payments include:

- *Where the outflows go:* trade and payments data show that 50–60% of imports are from the US and 70–80% of services payments go to US companies (airlines, shippers, banks, insurers, health providers, lawyers, etc.). The annual total outflow to US suppliers is \$50–55 million, somewhat higher than the annual inflow received by the RMI for Kwajalein access and the base grant. In 1999, retained petroleum products at around \$11 million accounted for about 17% of net import payments. Oil prices have risen to double 1999 levels over the last twelve months and there will be a significant flow on to local operating costs.

Figure 2: Balance of Payments, Current Account, 1995–2000



Source: Statistical Table A3.16

- Classification and impact of Compact flows:* Box 2.1 describes how Compact payments are classified. Payments for nuclear compensation and access to Kwajalein were formerly classified as grants (“unrequited transfers” in BoP terminology). That was clearly incorrect. In Table A3.16 the Kwajalein rents have now been classified as “other net income.” The untied Compact inflow—the base grant—is also clearly identified. The table still understates the effect of Compact-related flows, partly because nuclear compensation is disbursed from funds already received and held in trust, and partly because of the problem of valuing for BoP purposes activities performed by US nationals under various programs.²⁰ The total of s.211 base grant receipts

²⁰ Outside but related to the Compact, and posing similar BoP tracking problems, the US Department of Energy is said to be spending \$7 million annually on monitoring and cleaning up nuclear-damaged sites and monitoring residual health risks in affected areas. Some of these expenditures take place in the RMI; probably less than half become part of the RMI balance of payments.

Box 2.1: Classifying Compact Payments

The Compact of Free Association between the RMI and the US came into force in October 1986. The preamble speaks of fundamental rights and freedoms, trusteeship and self-determination, but the Compact is best understood as a contract, under which a sovereign but very dependent RMI sells certain rights and protections to the US, in consideration of specific undertakings by the US Government. The RMI agrees to protect the US against legal action by Marshallese for compensation for loss and injury from nuclear testing, in return for a set of financial and medical support arrangements. The US acquires the right to exclude military activities by other countries from the RMI and to carry on military activities there itself under separate agreements to be made. The US may not test or deploy nuclear or chemical weapons in the RMI without the agreement of the RMI, except in time of war. In return the US undertakes to defend the RMI "as the United States and its citizens are defended" and to make certain payments to the RMI under the Compact and separate agreements.

These agreements and payments have dominated the RMI's social and economic life for fourteen years and continue to do so. In an economic sense they fall into four categories: compensation for nuclear loss and injury, payments for access to Kwajalein military base and missile range, a basic grant to the RMI Government, and federal program expenditures requested by the RMI. The first two categories are clearly not official development assistance (ODA) in the accepted meaning of the term; they are payments for damage done—somewhat akin to insurance compensation—and for access rights, and their use is not controlled by the Government. The second two may arguably be classified as ODA, on the basis that globally most bilateral ODA is provided as part of an aid/trade/strategic relationship with benefits to both sides. The relatively large amounts paid to the RMI on a per capita basis reflect the important strategic benefits obtained by the US.

The Compact deals with nuclear compensation by establishing a trust fund of \$150 million, and committing the US to continuing work (outside Compact funding) to monitor human and environmental conditions. Under a separate agreement the

Box 2.1: Classifying Compact Payments *(continued)*

expected²¹ income of the trust fund, at an average of 12% or \$18 million a year, was precisely allocated to injury compensation of individuals, and to the economic/social development of the communities on the four atolls directly affected by nuclear testing. A claims tribunal was set up and began processing a flow of claims. Trust funds were set up for the four atolls and various programs were started using the distributed funds. In the low-interest environment of the last 10 or 12 years, the underlying fund income has averaged nearer 8%, well below the level of predetermined commitments. This led to the need to commit principal monies from the main fund²² much sooner than was the original intention. New medical evidence has caused the RMI to request a review of the nuclear compensation provisions under the "changed circumstances" clause of the separate agreement, with a view to substantially increasing the funds available.

The Kwajalein payments are larger than some statistics recognize, and the bulk of them are made by the RMI Government from the base grant under Compact s.211. Under the Land Use Agreement between the RMI Government and the owners of land rights on Kwajalein, payments to the Kwajalein Atoll Development Authority (KADA) for development projects on the atoll (in effect, on Ebeye and adjoining islands) are included in the access deal. These payments amounted to \$51 million from 1986–99 and are running at \$4.3 million annually. The KADA payments come from the Government's s.211 base grant, where they count as part of the Government's obligation to spend 40% of the grant on development projects.

Rent payments made by the Government, also from the s.211 base grant, are \$4.3 million per year, with an inflation top-up of \$2.3 million from s.217 (see below). The US also makes an annual

²¹ The designers of the Compact were influenced by the interest-rate experience of the 1970s, and expected higher inflation and higher nominal yields on US treasury bills during the Compact than turned out to be the case. These expectations were built into the Compact and have considerably complicated its implementation.

²² Nuclear compensation under the Compact is often described as the fund's original principal of \$150 million plus its total investment earnings, which had reached \$144 million by September 1999. Of a total of \$294 million, \$217 million had been distributed, leaving a fund principal of \$77 million.

fixed payment of \$1.9 million under s.213. These payments to owners of land rights add up to \$8.5 million annually. The Government deducts a 3% tax, worth \$0.25 million, from these payments and the 84 recipients divide \$8.2 million among themselves and their dependents, with the bulk (\$2.7 million) being shared and redistributed by three *iroj*. Kwajalein thus receives about \$12.8 million annually, or just under one-third of the \$39 million Compact funding in the Government's annual budget. The existing agreement commits both parties to a second 15-year term.

There is a fifth payment category in the Compact, the inflation adjustment provided by s.217. This is intended to maintain the real value of the base grant, and hence most of the Kwajalein payments, over the 15-year period. As the base year is 1981 and the inflator is two-thirds of the US GNP annual price deflator, which was a significant amount in the early years of the Compact, this provision has generated very large additions to the original dollar amounts. By September 1999, \$124 million had been received as "inflation adjustment" on top of \$354 million of base grant payments. Note, however, that nuclear compensation payments through the \$150 million trust fund were not adjusted for inflation.

(including Kwajalein payments) and disbursements under the nuclear compensation program is roughly equivalent to the RMI's merchandise imports. As noted earlier, a reduction in Compact flows unmatched by an increase in other sources of funds or a decrease in non-import outflows must result in a reduction in imports.

- *The importance of debt service:* for many years payment of interest and principal (debt service costs) on public sector debt, comprising government and state-owned enterprise bond issues, has run at \$25–26 million annually (about 27% of estimated GDP), preempting the major part of Compact receipts. Within the government budget there has been a similar effect (see following sections). The biggest of these bond issues will be fully repaid in 2001, relieving the balance of payments and the budget of a crippling burden, and providing an opportunity for financial stabilization through government saving that must not be missed.

- *The role of foreign direct investment:* with the exception of 1998/99, this is conspicuous in the balance of payments by its absence. Normally foreign direct investment is the best way for a developing country to obtain access to capital, know-how and markets, but it has proven an extremely difficult source for the RMI to tap because of the economy's small size, remote location, uncompetitive cost structure, and other impediments. The striking exception in 1999 was the establishment at Majuro of a tuna loining plant at a cost of about \$5 million. The plant is owned by foreign fishing and shipping interests, which provided about 60% of the capital required. The balance of \$2 million was domestically financed by a loan from a local bank secured by a matching deposit by the Marshall Islands Marine Resources Authority (MIMRA). The factory employs 350 workers, 80% of them women, mostly at rates significantly below the legal minimum wage. There is no shortage of women willing to work at these rates. The enterprise pays social security contributions, but was exempted from all forms of national and local government taxation for a period of 25 years by a special statute. These terms have since been modified by renegotiation but they illustrate the lengths to which the RMI has had to go to obtain foreign direct investment, even in a sector of comparative advantage and currently burgeoning activity (see below on the climate for investment).

Government Finance

Public financial management. The financial operations of the RMI Government, as for most small countries, are crucially important to the performance of the monetary economy. The integration of the RMI into the US monetary system means that the supply and price of money for the RMI's economic factors is reflected in autonomous flows in the current or capital ac-

counts of the balance of payments, somewhat moderated by the impact of the Government's fiscal policy in saving money (taking it out of circulation) or spending it, at home or overseas.

The goals, policies, and effectiveness of public financial management are therefore critical for the proper functioning of the economic system. Government expenditures in FY2000 are estimated to have been just over \$57 million, about 60% of estimated GDP. The Government has acknowledged²³ serious and substantial problems in fiscal planning, budgeting, accounting, and control that urgently need to be addressed. The approach currently being taken was under discussion during the preparation of the report and is described in Box 2.2. It is extremely important for the RMI's economic well-being that rapid progress is made with these improvements at the heart of fiscal governance.

Revenue. The Government's sources of funds are dominated by foreign grants. In the 5 years to 1999 these averaged \$42 million annually, accounting for 58% of the Government's income, with Compact grants alone at an average of \$33 million and accounting for 45% of total income. Non-Compact grants from other bilateral sources have been growing in the last 3 years and are now running at about \$7 million annually. All forms of tax revenue account for one-quarter and non-tax revenues for 11% of receipts, with fishing license fees²⁴ at over \$4 million providing nearly half of that. Tax revenue, now around \$15 million annually, has fallen by \$3–4 million since general import duties were reduced from 10–12% to 5% in 1998. Currently income tax²⁵ produces about half of all tax revenues,

²³ *Inter alia*, by the President's appointment in April 2000 of a Blue Ribbon Panel to report on the use of Compact funds and the "effectiveness and efficiency of the RMI's financial policies and practices." The proposals in Box 2.2 draw heavily on the panel's work.

²⁴ See Chapter 8 on the noteworthy arrangement whereby MIMRA collects fishery license revenues and applies them to its own budgetary needs before passing the balance on to the Treasury.

²⁵ Incomes from \$1,040 to \$10,400 are taxed at 8%, and incomes above \$10,400 are taxed at 12%. Kwajalein lease income is subject to a 3% flat withholding tax deducted at source.

Box 2.2: Strengthening Public Sector Financial Management

The Government proposes to make strong and verifiable commitments to strengthening public financial management in the conditions of a program loan that it plans to borrow from ADB early in 2001. The recommendations of the Government's Task Force on Accountability, together with inputs from technical assistance provided by ADB and the Pacific Financial Technical Assistance Center, have guided the drafting of this planned policy commitment. It is summarized below:

Aim: establish clear and robust systems of annual and medium-term budgeting, financial control, accounting, internal audit, and reporting to the *Nitijela* (House of Representatives).

Annual budget: detailed estimates are to be presented to the *Nitijela* in support of the annual (and any other) Appropriation Bill. These estimates are to show, in a clear and readily understandable format,

- total estimated revenue, expenditure and expected budget balance;
- how to use any estimated surplus or finance any deficit;
- the expected sources of revenue, with reference to the legislation empowering its collection;
- the allocation of expenditure to heads, subheads and items, in sufficient detail to show clearly how public moneys are to be spent on which government policies and programs;
- against each head of expenditure, a summary of the policies, programs and specific performance targets that are expected to be achieved during the budget year;
- comparative revenue and expenditure for the current and previous fiscal years;
- statements of opening and closing balances and flows of funds for all public financial assets and liabilities, including trust and special funds, for the last two fiscal years and the budget year; and
- statements of external aid programs, balances, proposed disbursements, and commitments.

Medium-Term Framework: The annual budget estimates presented to the *Nitijela* are to be accompanied by a Medium-Term Budget Framework, linked and cross-referenced to the annual Economic Policy Statement (see references in main text). The budget framework will present a 4-year statement of the government budget, by main heads of revenue, expenditure, and financing, organized in accordance with the government finance statistics format. The first year of the framework will be the current year, showing the latest revised estimates. The second year will be the year for which the estimates are being submitted to the *Nitijela* for appropriation, and the allocations to heads will be as in the estimates. The third and fourth years will show estimated revenues based on current policy, and the allocations of expenditure that would result from implementation of the policies and programs approved by the Cabinet. Allocations will refer to the appropriate passages in the accompanying Economic Policy Statement.

Financial control: provisions are to be put in place to prevent unauthorized expenditure from the General Fund and to limit expenditure from Trust or Special Funds to the unexpended balance of each fund. The power of the Government to authorize expenditure in excess of the total appropriation will be limited to a specified fraction of the original appropriation, and restricted to urgent and unforeseen circumstances. The power of the Minister of Finance to move funds within the estimates will likewise be strictly limited and its exercise required to be promptly reported to the *Nitijela*. Significant penalties are to be provided for breach of these rules. Delegations of authority to accounting officers will be linked to strict reporting and sub-control requirements. Power to restrict expenditure for cash-flow reasons will be retained by the Minister of Finance. Bank accounts will be consolidated and control/recovery of imprests tightened.

Use of credit facilities will be controlled by the Secretary for Finance. The Public Accounts Committee of the *Nitijela* is to be made effective as the principal forum of government accountability to Parliament.

Accounting: the accounting system will be overhauled and/or replaced. The existing system is defective, and its output requires costly on-site support by its installer, based in Washington DC. Daily position statements, weekly cash flow analysis, and monthly statements of account to the Minister of Finance are to be established, leading to semi-annual statements to the *Nitijela* com-

**Box 2.2: Strengthening Public Sector
Financial Management** *(continued)*

prehensively setting out the Government's financial position. Accounting officers are to be required to reconcile their accounting records with the central government accounts at least monthly.

Internal audit: an internal audit unit is to be established within the Office of the President or the Ministry of Finance. The unit will monitor adherence to financial regulations and procedures, and compliance with budget allocations and controls; investigate wasteful or inefficient practices; and recommend operational improvements.

Reporting: a comprehensive structure of reporting will be put in place, designed to take up minimum time in report preparation but detecting and requiring explanation for any significant divergences from budget, and culminating in an annual report to the *Nitijela* by the Secretary (not Minister) for Finance.

import duties (at their currently reduced level) about one-quarter, and gross revenue tax²⁶ about one-quarter.

The tax regime is open to criticism on several counts, and has been the subject of several reform proposals. Administrative capacity to implement reforms is a constraint, at least in the short term, and there are strong indications—among them a steady flow of complaints of unfair treatment, by taxpayers who see their competitors operating tax-free—that the existing tax regime is not collecting the revenues that are due. The first need is therefore to drastically tighten up collection. Once that is in hand, consideration can be methodically given to redesigning the tax system for greater efficiency and equity. It is important that any changes should be designed to be feasible with existing resources, and that they should have political and community support. The main issues in taxation are as follows:

²⁶ The gross revenue tax is 3%. There is no corporate profits tax. A 3% gross revenue tax is equivalent to a 30% profits tax on an enterprise whose taxable profits are 10% of gross revenues.

- By regional and international standards, *personal income tax* is high for the lowest-paid wage earners²⁷ and low for the middle and upper income brackets.²⁸ This suggests that a greater contribution to the costs of the services and operations of the nation-state could reasonably be made by people who receive the larger share of wage and non-wage incomes. The tax-free allowance could be raised to several times its present level to improve the lot of lower-paid workers (and greatly reduce theoretical roll of taxpayers), and the top marginal rate could be raised to regionally comparable levels.²⁹ The tax could also be applied to non-wage income such as interest and rental for land and buildings (including Kwajalein), with appropriate allowance for expenses incurred in generating the income. This would have a marked beneficial effect on the equitable distribution of income and services, through government revenue and expenditure, with no damage to the RMI's economic competitiveness.
- The *gross revenue tax* is simple in concept and theoretically easy to administer, but it is paid on gross output value at each stage in the produce/process/sell chain, producing a cascading effect of tax being paid on tax. The gross revenue tax takes no account of enterprise profitability, as a good business tax should, and it is commonly reported to be subject to widespread evasion and under-collection.
- *Import duties* were reduced in 1998 for election-related reasons and are now well below regional average levels. Duties can be restored to the 10–15% range with no damage to the RMI's economic competitiveness.
- *Local taxes*: an already confused tax picture is further fragmented by the wide taxing powers of local govern-

²⁷ At present, a person earning the statutory minimum wage of \$2 an hour is liable to pay 8% tax on three-quarters of his or her salary, a tax payment of \$250 a year. Most comparable countries do not impose income tax at such low income levels.

²⁸ A person earning \$25,000 is liable to pay \$2,500, an effective rate of 10%. At \$100,000, the effective rate is 11.5%. Comparable rates in the region are 20-30%.

²⁹ For example, 25% on an income of \$25,000 and above, with two or three steps between the bottom and the top rate.

ments. Anomalies are created by uncoordinated taxing actions at the local level, potentially negating the fiscal intentions of the national Government and compounding the problems of the taxpayer. Statutory and administrative action is needed to integrate national and local taxation into a single scheme that, for example, limits levels of local tax, allows offsets against national tax liabilities, and is simple for the taxpayer to understand.

- The introduction of a *value-added tax* was proposed as part of an earlier comprehensive review of taxation in 1996. The idea met resistance from the commercial sector, and the overall tax reform plan was abandoned as a national election approached. However, a value-added tax offers efficiency and equity gains to the community at large, has been successfully introduced in several small economies, and should stay on the agenda for further examination.

The *comprehensive review of taxation* proposed in 1996 should now be revived and undertaken during 2001. Discussion of draft terms of reference at the Second National Economic and Social Summit (NESS 2) would provide an opportunity for public input to design of the task. Agreed changes emanating from the review could then be implemented in 2001/02, at the same time as the new Compact arrangements are being put in place.

Expenditure. The Government's use of funds in recent years has been largely shaped by the wage and salary cost of the public service, subsidies and current transfers, and the cost of servicing the public debt. Over the period FY1996–2000, the public service has absorbed 36% of the Government's current expenditures, and subsidies and current transfers a further 16%. The dollar value of these outlays has fallen by 15–20% since 1996 as a result of the Government's public sector reforms, but 2000 saw a blowout in transfers to rescue the Social Security fund, and their combined share of recurrent expenditure is still over 50%. The cost of debt service (payments of interest and principal on government overseas debt) has averaged over \$28 million a year, accounting for just over 40% of the total income of the Government from revenue and grants over the last 5 years.

As FY2001 opens, the Government is in severe financial straits, squeezed between lower revenues and difficult-to-cut expenditures. The FY2000 budget was designed to be balanced but ran out with a deficit close to \$5 million. The FY2001 budget is also expected to be in substantial deficit. Cash reserves have been exhausted and unpaid debts are accumulating. A blend of crisis-management measures—short-term commercial borrowing, lay-off of staff, postponement of expenditures—will have to be used to tide over the immediate cash deficit. Changes to import duties and income tax rates under existing laws, as discussed above, may be made without waiting for the comprehensive taxation review. This would increase annual revenue flows by several million dollars, while quickly producing some much-needed cash from import duties.

As 2001 advances, the position should gradually improve, though very tight expenditure control will still be required. The first \$6 million tranche of a program loan for \$12 million—under negotiation with ADB at the end of 2000—should become available by mid-2001, provided agreement is reached on supportive fiscal policies. Additional revenue from tax increases, if these are put in place early in the year, will also come to hand. With the 2001 bond repayments, \$122 million of debt will be paid off and annual debt service will drop from \$24 million to \$6 million, freeing up \$18 million of annual inflow for the remainder of the Compact.³⁰

Government Saving. At that point it will be immensely important that the Government fulfills its intention to set aside maximum savings into the Marshall Islands Intergenerational Trust Fund (MIITF), so as to generate uncommitted future income on a sustainable basis. However strong the pressure on the Government to spend money for political and social purposes, it is critically important for the achievement of the goals

³⁰ Should the imminent negotiations about the Compact financial arrangements not be concluded by October 2001, as seems quite possible given the lengthy processes required on the US side, a negotiating period of not more than two years will be triggered by section 231(b). This provides for basic grant and related payments during the two-year period to be at the average level of the first 15 years, an increase of about 17% above the levels of the final stepped-down period.

set out in this report that the greater part—that is to say, between two-thirds and three-quarters—of the “windfall” funds expected in 2001-2002/03, be saved into the MIITF. That is the best possible way for the Government to show its own people and the outside world that it is intent upon greater self-reliance. With a Government contribution to MIITF of \$25–30 million in 2002/03, the foundation can be laid for a steady flow of Compact-derived (and potentially other external) contributions to create a sustainable \$0.5–0.6 billion fund over the following decade.³¹ Meanwhile, a review of the MIITF law and associated administrative and financial arrangements is required to make as certain as possible that the fund will be protected against misuse for political or any other ends.

Employment

Data. The 1999 census found a working age population, defined as persons aged 15 years and over, of just under 28,700 or about 56% of the total population. Of these, 51% or 14,700 persons were classified as economically active—5,000 women and 9,700 men—and make up the labor force. As the official report points out, these figures have to be treated with some caution because of classification problems,³² but assuming these were similarly handled in 1988, the labor force grew between censuses by 28% while the total population grew by only 17%. Most of the increase was among females, whose participation rate in the labor force grew from 15% to 20%, while the male participation rate remained around 37%.

Out of a labor force of 14,700 the census found just over 10,000 or 69% to be employed. This is almost exactly the same number as in 1988. Data in Chapter 3 of this report shows that

³¹ Recalling the problems created by wrong assumptions about interest rates in the Compact nuclear compensation arrangements, conservative estimates of fund earnings and distributable income should be used in designing the MIITF and setting annual contribution levels for the RMI and US governments.

³² For example, of the 177 persons more than 65 years old who were reported as “economically active,” 174 or 98% were classified as employed, a higher proportion than any other age group.

the number of jobs in the public service was almost the same too, at 1,750 including vacancies in 1988, and just under 1,500 without vacancies in 1999—after the reduction-in-force process was almost complete. But the number reported as employed in 1999 is a smaller proportion of the labor force than in 1988. There are now three times as many reported as unemployed, 4,500 instead of 1,400, and the proportion of females without work has risen.

Again, caution is needed. Employment includes self-employment as agricultural workers or fishers, which accounted for 20% of the total, almost 90% of them male. About 7,200 workers were classified as employees, while about one-tenth of that number were self-employed or employed in sectors other than agriculture and fishing. Three out of every ten employed persons were female, but they outnumbered males only in the “clerical and related workers” category (1,365 workers, 61% female). Employment in the “public sector” category accounted for 3,100 persons or about 6% of the population, of whom (from separate data) about 1,500 were in the public service.³³

Issues and policies. The key development issue here is the manifest inability of the formal employment and small business/self-employed sector, inevitably concentrated on Majuro, to absorb new entrants into the labor force. There are 1,200–1,500 young persons in each year age group between 10 and 19. Over the next 10 years, about 800–1,000 of them will enter the job market per year. They will enter at different times according to their years of schooling (one in seven is not in school at all). At the other end of the labor force age structure around 200–300 persons a year are retiring or dropping out of active work, making room for newcomers. This indicates a need for 600–700 new jobs or self-employed small business opportunities a year to broadly keep up with population growth and existing desire-to-work ratios.

The total lack of net growth in employment between 1988 and 1999, during a period when vast sums were being spent on

³³ Given the variations of definition and function among countries, the RMI does not now have a very large public service by regional standards, but see Chapter 3 on efficiency and wage rates.

stimulating economic growth, suggests that it will be difficult to find even a fraction of the jobs that would be needed to achieve such an equilibrium. With the best of good fortune and expanding markets for atoll-lagoon marine products, tuna transshipment services and atoll/historical tourism (all of which are far from certain to occur), the potential for new jobs is probably in the range of 100–300 a year. There are already signs of increasing stress in the Majuro and Ebeye communities. The prospect of several hundred additional young people every year being unable to find work or self-employed opportunities raises serious concerns about social stability and security on Majuro, Ebeye, and the rural atolls.

Every effort should be made to make the RMI a competitive and attractive place for foreign direct investment, and for profitable expansion of existing enterprises. Strategies to this end are identified in this report. These efforts can be expected to lead to real economic growth and an increase in jobs. But there is no reasonable prospect of that growth being sufficient to absorb the increasing numbers of people who will be looking for work.

In these circumstances it is most important, first, that the ready access provided under the Compact for Marshallese to live and work in the US be carefully preserved and scrupulously used; and second, that young people be equipped by the education system with the skills and attitudes they will need to make their way not only in the RMI, but also in the US and elsewhere in the Pacific region.

Even then, with a steady outward movement in place, there is likely to be a noticeable rise in open unemployment on Majuro and Ebeye, with potentially serious risks to the unemployed themselves and to society around them. All the resources of the RMI community will be needed to manage this unavoidable development, and as far as possible turn it to positive outcomes.

Competitiveness and Investment

The need to compete. Among the economic lessons the RMI has been learning is that to achieve lasting growth it has to attract

long-term commercial investment from existing and/or new investors, and to do that it must be internationally competitive. A small remote economy cannot afford to make things difficult or expensive for potential investors—be they foreign or local. In the last few years important improvements have been made to the process for approving and licensing foreign direct investment. A statement of investment policy has been made and the law amended to implement easier and quicker procedures. The Trade and Investment Division of the Ministry of Resources and Development (MRD) has been reestablished with up-to-date aims to cover the promotion of investment and trade and to support the growth of small businesses. There is still more to be done. The aims and methods of investment promotion need to be more sharply defined, regulations simplified and fees greatly reduced. Moreover, positive moves at the sector level now need to be supported by macroeconomic policy changes designed to improve the country's competitiveness.

In a deregulating and globalizing world, the cost of setting up and doing business in the RMI has to be compared with other feasible locations. Most of the RMI's potential competitors are closer to markets and have a more versatile economic environment to offer an investor. To compete effectively the RMI has to try harder. Three important structural obstacles remain to be removed:

1. lack of secure leasehold title to developable land,
2. a confused and inefficient taxation system, and
3. public perceptions of official corruption and inefficiency.

Action is afoot to deal with the first of these, with the tabling of a draft law to establish registration of 'development land' that would be available for lease to investors under government-guaranteed title. The passage of this law and successful establishment of an authority to implement it will go a long way towards removing this troublesome obstacle.

The second problem should be dealt with in a comprehensive review of taxation recommended earlier in this chapter.

The third requires continued conscious effort to make publicly transparent and accountable the processes and deci-

sions of ministers and officials, and to punish those who break the law or who fail to maintain an acceptable standard of conduct for holders of public office. The credible independence of the police and judiciary from political or official interference, and a perceptible shift from traditionally unified governance to a constitutional separation of powers will be important factors in the ability of the RMI economy to attract long-term private investment. Discussion of these matters at the planned NESS 2 may provide pointers in the direction that action should take.

A different kind of obstacle to investment is presented by the RMI's use of the US currency. The costs and benefits of this are reviewed in Box 2.3, which concludes that on balance the use of the US dollar benefits the RMI. No change is therefore proposed. The tendency of the currency to strengthen against other currencies reflects global perceptions of the benefit of holding US dollars. The US economy can live with this trend by using the vast financial inflows it attracts, and by making continuous gains in industrial productivity. The RMI is in a different league on both counts. An appreciating currency makes it harder for domestically produced goods and services to compete in export and import markets. To offset this, the RMI will have to be extra competitive wherever it can. Specifically, real wages and rents will have to fall—that is to say, there is no room for increases to offset inflation—and most likely average nominal wage levels will have to fall, squeezing household consumption expenditures significantly. This need has already been implicitly recognized by the recent waiving of the minimum wage requirement for the tuna processing project. The trade-off is between more jobs at lower wages, or shrinking employment prospects at existing wage levels.

Those are all obstacles that get in the way of a positive decision on investing in the country, whether by a new investor thinking of starting up or an existing enterprise considering expansion. There is no economic case for treating the two categories differently: the investment climate should be the same for all comers, new and old.³⁴ Moreover, if the goods and services

³⁴ Within that climate, Marshallese start-up businesses should have access to business advisory services and security enhancement facilities—see Chapter 6.

Box 2.3: Using the US Currency

The RMI uses the currency of the United States because the US was its last colonial ruler before independence, and there has been no persuasive reason to change the arrangement since then. That is still the case. Both costs and benefits flow from the use of the US dollar as the domestic currency of the RMI. Some of the outcomes may be perceived as either cost or benefit, depending on the political philosophy or economic situation of the observer, but in terms of the goals and strategies defined in *Meto2000* the balance of argument still weighs against change. The downside of using the US currency is mainly to do with the limits this places on the policy options for economic management that are available to the RMI authorities. This limitation is in two parts.

First, the exchange rate of the currency—the nominal price at which the RMI buys and sells goods and services with the world outside the US—is determined by the performance of the US economy and international capital markets, which know little and care less about the situation and needs of the RMI. The Government cannot usefully have a policy about the nominal exchange rate.

Second, use of the US currency integrates the RMI into the US financial system, so that financial flows—in the form of physical movement of cash or electronic exchange of assets and liabilities—take place outside the knowledge or control of RMI authorities. Monetary policy, which would be aimed at influencing the supply and price of money and credit in the RMI in such a way as to promote investment and growth, is thus also a non-starter.

The *nominal exchange rate* is problematic for the RMI's development goals, because the tendency of the US currency to appreciate internationally makes goods and services produced in the RMI expensive in global markets—which include tourism, servicing fishing vessels, handicrafts and any onshore processing of marine resources—and foreign (non-US) goods cheap. The result is that the domestic economy stagnates and people buy foreign goods, a reasonable description of the RMI's situation.

To counter this, the *real exchange rate* has to be targeted:

Box 2.3: Using the US Currency *(continued)*

this adjusts the nominal rate by also comparing domestic price movements between trading partners. If the RMI can both *improve productivity* and *reduce domestic inflation* to very low or even negative levels, it may be able to live with the US currency and still be internationally competitive. Prices based on cost of production in the RMI may then still be low enough, when converted to other currencies, to attract domestic/foreign buyers/investors. At the same time, the general level of import tariffs can be used—in moderation so as not to feed back into traded-goods production costs or attract World Trade Organization-related criticism, but still to good effect—to adjust import prices to make room for domestic products in local consumption baskets.

As already noted, the lack of a *monetary policy* option in the RMI arises because resident businesses or households can make financial transactions with any part of the US system, and through that, the rest of the world, if they don't like monetary conditions in the RMI. There is no practical way of changing that so long as the RMI uses the US currency. This also imposes a fiscal constraint on the Government. The Government can only obtain money by taxation, fees, investment income, grants or public borrowing: it can't switch on the printing presses to finance its deficit. As the nominal exchange rate is set by forces far outside RMI influence, this means that of the four conventional tools of macro-economic management—exchange rate, monetary, fiscal and incomes policies—available to governments, only the last two are open to the RMI. It follows, as *Meto2000* argues, that what the authorities do about the sustainability of the government budget, and about wage levels and labor productivity in the economy as a whole, are of paramount importance to the RMI's economic prospects.

The upside of using the US currency is that, provided the resulting constraints on policy-making are understood and wherever possible turned to advantage, the loss of policy options may not be a bad thing. Many developing countries that embarked on independence with a national currency have subsequently resorted to monetization of budget deficits ("printing money"), followed by manipulation of the exchange rate and monetary policy in a doomed effort to protect the currency's value from the consequences of failures of fiscal and incomes policy. It is precisely the *lack* of scope for

such government intervention—notoriously leading to unsustainable overvaluation of the currency and repressive regulation of the domestic banking system, followed inevitably by devaluation and the near-collapse of financial institutions—that lends a sense of stability and resilience to the RMI's financial system. For such a small, remote economy that would in any case be perceived as carrying an investment risk premium, the use of an established international currency is almost certainly a positive factor in the perceptions of both existing and prospective investors.

Should that international currency be the US dollar? The very close financial and other links between the RMI and the US suggest that it should be, on grounds of cost and convenience, unless there are very strong arguments for a change. The main developmental drawback of the US dollar is its recent tendency to appreciate against the currencies of the RMI's existing and hoped-for trading partners. On the grounds that this trend is likely to ease, and may well reverse over the next year or so as Asian and Australasian economies recover and the US economy slows down, this is not the time to make a change. The possibility should be reviewed no later than the next review of goals and strategies, proposed for 4 years from now.

produced in the RMI are not competitive in price and quality with those produced elsewhere they will not be purchased, either by residents of the RMI or by anyone else. So competitiveness is not just about attracting new businesses to start selling in export markets. It is also about being able to sell locally in competition with imports, and making it feasible for existing enterprises to expand. Just as it is the net effect of the whole set of conditions that has to be positive, so it is the sum of the whole bundle of input costs that has to be competitive rather than each item. Thus some "cross-subsidy" can exist within the bundle—e.g., high wage levels could be offset by low-cost access to land and utilities—but overall the cost of the RMI's input bundle must compete with those of other possible locations for new investment.

Investment potential. The RMI has derived major financial benefits from the sale of sovereignty services,³⁵ most obviously by selling exclusive strategic military access to the US and oceanic fisheries access to the US and other fishing nations, and by successfully marketing the RMI shipping registry. The scope for hanging domestic economic activity on these successes is still—apart from the tuna loining plant—largely unrealized. At the same time autonomous domestic economic activity is most likely to succeed in areas of comparative economic advantage, where non-financial factors such as uniqueness can outweigh the RMI's remoteness and high cost structure. These appear to be niche-market, atoll-based marine resources and tourist activities—with scope for linking the two in an atoll-environment/outer island development program (see Chapter 9).

Military bases, foreign fishing fleets, and atoll-based marine resource and tourism activities all require a bundle of goods and services to be supplied at competitive quality and prices. These include land leases, fuel, utilities, food and handi-crafts, maintenance and repair services, entertainment, financial, technical and personal services, transportation and communications, and the personal and corporate security environment—an intangible product of government, governance (legal and judicial), and social structure.

The tuna loining plant provides a welcome bright spot on the investment scene. Neatly combining the potential of sovereignty sales and comparative economic advantage, in the last 3 years MIMRA has successfully marketed Majuro as a competitive tuna transshipment port. A strategic location for the central Pacific tuna fishery, a spacious all-weather harbor, two deep-water berths and a dry dock, duty-free fuel supplies,

³⁵ There are constraints on what is feasible in the area of sovereignty services. Like a number of other small states, the RMI has experimented with licensing offshore banks and selling passports. In both cases this aroused the hostility of countries whose friendship is important to the RMI, and who felt the integrity of their own sovereign systems was threatened by the RMI's activities. The shipping registry has not incurred the same hostility. A pragmatic approach to sovereignty services, on the look-out for opportunities that are both profitable and internationally respectable, seems appropriate.

reliable shore-side power, well-stocked supermarkets, and international airline services for crew changes all combine to draw purse seiners and their carrier vessels to Majuro. Not only vessels fishing in the RMI's exclusive economic zone (EEZ) transship at Majuro. The competitiveness of the Majuro goods and services bundle attracts vessels that could have transshipped elsewhere in the FFA region. The \$5 million, 350-job tuna processing plant is a direct result of the promotion of transshipment facilities. More investment is needed ashore to capture the full benefit of the market for vessel maintenance and repair services, but the processing development—which has potential for expansion—already shows that intelligent exploitation of comparative advantage can bring positive structural change even to an otherwise uncompetitive economy.

In the same vein of linking sovereignty and comparative advantage, and in the context of the Compact renegotiation and extension of the Kwajalein leases, the scope for increasing the domestic procurement of goods and services for the Kwajalein base should be investigated. At present the requirements of the base are sourced in bulk by the principal contractor to the US Government. A joint task force of the United States Army at Kwajalein Atoll (USAKA), the RMI Government, and Chamber of Commerce could appropriately be set up to examine the procurement lists of USAKA, and identify products and services that could feasibly be produced and/or procured locally. Outlines could be prepared of the technical and financial parameters that would need to be met, both by USAKA and any commercial supplier, for such activities to be viable, and the news of potential contracting opportunities disseminated. As there may be significant economic potential in this, it should be explored in association with the forthcoming Compact negotiations.