ASIAN DEVELOPMENT BANK **PPA: RMI 29658**

PROGRAM PERFORMANCE AUDIT REPORT

ON THE

PUBLIC SECTOR REFORM PROGRAM
(Loan 1513-RMI[SF])

IN THE

MARSHALL ISLANDS

December 2003

CURRENCY EQUIVALENTS

The Republic of the Marshall Islands uses the US dollar as its currency.

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AMI	–	Air Marshall Islands
CG	–	consultative group
CIF	–	cost, insurance, and freight
Compact	–	Compact of Free Association with the United States
COS	–	country operational strategy
CPH	–	census of population and housing
FFMP	–	Fiscal and Financial Management Program
FRTF	–	Financial Reserve Trust Fund
FY	–	fiscal year
GDP	–	gross domestic product
GFS	–	government financial statistics
GRT	–	gross receipts tax
HDI	–	human development index
HRD	–	human resource development
KAJUR	–	Kwajelein Atoll Joint Utility Resources
MEC	–	Marshall Energy Company
MIAA	–	Marshall Islands Airport Authority
MIITF	–	Marshall Islands Intergenerational Trust Fund
MIPA	–	Marshall Islands Ports Authority
MISSA	–	Marshall Islands Social Security Administration
MIVA	–	Marshall Islands Visitor's Authority
MOF	–	Ministry of Finance
MWSC	–	Majuro Water and Sewer Company
NGO	–	nongovernment organization
OEM	–	Operations Evaluation Mission
PAT	–	policy advisory team
PCR	–	program completion report
PIDMC	–	Pacific Island developing member country
PRP	–	policy reform program
PSIP	–	Public Sector Investment Program
PSMIP	–	Public Sector Management Improvement Program
PSRP	–	public sector reform program
PSU	–	private sector unit
RIF	–	reduction in force
RMI	–	Republic of the Marshall Islands
RRP	–	report and recommendation of the President
SDR	–	special drawing rights
SOE	–	state-owned enterprise
TA	–	technical assistance
UNDP	–	United Nations Development Programme
US	–	United States
VAT	–	value-added tax

NOTES

(i) The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2002 ends on 30 September 2002.

(ii) In this report, "$" refers to US dollars.

Operations Evaluation Department, PE-638

CONTENTS

BASIC DATA
Public Sector Reform Program (Loan 1513-RMI[SF])

TECHNICAL ASSISTANCE/INSTITUTION BUILDING

TA No.	TA Name	Type	Person-Months	Amount ($'000)	Approval Date
2755	Rationalization Committee for a Program Coordinator	Advisory	24	515	30 Jan 1997
2756	Institutional Strengthening in the Transport Sector	Advisory	15	575	30 Jan 1997
2757	Support of the Private Sector Unit	Advisory	20	760	30 Jan 1997

KEY PROGRAM DATA($ million)	**As per ADB Loan Documents**	**Actual**
Total Program Cost	12.0	11.3
ADB Loan Amount/Utilization	12.0	11.3

KEY DATES	**Expected**	**Actual**
Fact-Finding		18 May–31 May 1996
Appraisal		9 Sep–18 Sep 1996
Loan Negotiations		15 Nov–18 Nov 1996
Board Approval		30 Jan 1997
Loan Agreement		30 Jan 1997
Loan Effectiveness	1 May 1997	6 Feb 1997
First Tranche Release	6 Feb 1997	14 Feb 1997
Second Tranche Release	31 Oct 1997	22 Sep 1998
Third Tranche Release	31 Oct 1998	28 Jun 2000
Program Completion	31 Dec 1998	Jun 2000
Loan Closing	30 Jun 1999	28 Jun 2000
Months (effectiveness to completion)	26	38

BORROWER Republic of the Marshall Islands

EXECUTING AGENCY Ministry of Finance

MISSION DATA

Type of Mission	**Missions** (no.)	**Person-Days** (no.)
Fact-Finding	1	42
Appraisal	1	30
Program Review	5	62
Program Completion	1	5
Operations Evaluation[1]	1	45

ADB = Asian Development Bank, TA = technical assistance.

[1] The Operations Evaluation Mission comprised C.B. Amerling, principal evaluation specialist/mission leader; R.M. Sturton, economist/international consultant; and J.G. Tubadeza, senior evaluation officer/field social impact assessment.

EXECUTIVE SUMMARY

The Republic of the Marshall Islands (RMI) consists of more than 1,000 small islands covering an area of only 181 square kilometers, dispersed over 2 million square kilometers in the northern Pacific. Formerly a United Nations Trust Territory, the people of RMI voted in 1978 for independence in free association with the United States (US), its former trustee. RMI has a parliamentary system of government with legislative power vested in the House of Representatives, or the *Nitijela*, and a traditional Council of Chiefs that acts as a consultative body.

In 1979, RMI signed a Compact of Free Association with the US (Compact), which became effective in 1986. The arrangement provided generous grant assistance for 15 years, to 2001 (extendable to 2003). The aim was to strengthen the economy over the period with the ultimate objective of economic self-sufficiency. The Compact funding was designed to decline over the period with two "step-downs" after the 5^{th} and 10^{th} years. By the mid-1990s, RMI faced an uncertain future and had growing problems, including (i) the high level of external transfers had distorted the economy, which had a disproportionately large public sector and a small productive sector; (ii) the second "step-down," coupled with borrowing against future Compact receipts, had created a financial crisis; and (iii) uncertainty about the future amount of external assistance likely from the US or elsewhere after the end of the Compact. It became increasingly apparent that it was no longer possible to sustain "business as usual," and that serious economic reforms were inevitable.

In 1995, RMI asked the Asian Development Bank (ADB) to coordinate external support and to provide technical assistance (TA) for economic policy advice. In response, ADB funded a policy advisory team, which prepared a policy reform program (PRP), and outlined short-term financial adjustments and longer-term structural reforms. The PRP was designed to return the economy to financial stability and, in the longer term, set the country on a more sustainable course for economic growth and development. The Government endorsed the PRP as the centerpiece of its economic strategy, and presented it at the first consultative group meeting hosted by ADB in Manila in December 1995. To achieve the reform objectives, the authorities sought an ADB loan to fund the cost of (i) compensation to staff retrenched through a reduction in force (RIF); (ii) retirement of expensive commercial borrowing necessitated to support Air Marshall Islands, the national air carrier; and (iii) establishment of a financial reserve trust fund. In January 1997, ADB approved a loan for $12 million equivalent from the Asian Development Fund in support of a public sector reform program (PSRP).

The PSRP goal was to initiate a long-term reform program to avert a looming financial and economic crisis, and to set the economy on a more sustainable path of growth. Its four main elements were (i) fiscal stabilization and sound fiscal policies, (ii) privatization of public enterprises, (iii) public service reform, and (iv) measures to stimulate private sector development. Three outputs were specified: (i) short-term stabilization of the Government's finances, (ii) long-term structural stability of the Government's finances; and (iii) creation of an improved environment for the private sector.

The funds were to be disbursed in three tranches of $5.5 million, $3.5 million, and $3.0 million. The first tranche was disbursed in February 1997. The second tranche was to be released by October 1997, subject to fulfillment of six conditions, and general progress in carrying out the reforms. But release of the second tranche was delayed because the pace of reforms was found to be overly demanding, and because of difficulties in achieving the target reductions for downsizing of public services. The second tranche was finally released in September 1998, despite the failure to fully achieve two of the specific conditions: the RIF target

and establishment of the Financial Reserves Trust Fund. The Board agreed to release the second tranche, based on reported achievements. Also, there was broad agreement that further delays in implementation would adversely affect the progress and momentum of the reforms. The third tranche, subject to fulfillment of five specific conditions, was released in June 2000 with compliance of four conditions, and fulfillment of the outstanding second tranche conditions.

Although the looming fiscal crisis and stabilizing of government finances was the PSRP's most pressing concern in the short term, the Program's design placed greater emphasis on ensuring the long-term stability of government finances, and improving the environment for private sector development. There were 14 loan conditions to help stabilize the fiscal crisis, 24 loan conditions to support long-term fiscal stabilization, and 21 to support private sector development. Policies to support immediate fiscal stabilization included increases in customs duties, wage restraints, and reductions in operating expenditures and subsidies. In longer-term fiscal stabilization, the Program emphasized public sector restructuring, a RIF of public services, tax reform, and establishment of a trust fund. In terms of developing the environment for the private sector, the Program emphasized reform of the state-owned enterprise (SOE) sector, with a limited range of conditions relating to the regulatory environment of the private sector.

For short-term fiscal stabilization, policies to increase revenues centered on increasing customs rates, removing exemptions, and improving administration. But increased customs taxes, achieved before loan effectiveness, were again reduced as the 1999 election approached. Customs taxes were increased again in 2002, although at lower rates than at the start of the Program. Although the list of private sector exemptions was reduced, the public sector, including SOEs, remains tax-free, and little progress has been made in improvement of tax administration. On the expenditure side, greater progress was made in reducing operating costs, instigating a wage freeze, and reducing subsidy levels. But while operating expenditures were reduced during the Program, aggregate demand also fell. That, coupled with a lack of revenue, decreased revenue collection and increased the operating deficit.

The RIF was the most significant of the long-term attempts to improve government finances. When the Program began, RMI had an estimated 1,944 civil servants. A target reduction to 1,484 was set. After 2 years of delays, the target was finally achieved by the time of the third tranche release. But at the time of the Operations Evaluation Mission, the number of public servants had risen to 1,868—only 78 short of the number when the RIF began, and payroll costs were higher than before the start of the Program began. The increased payroll was partly because of the failure to restructure Government, and to privatize domestic shipping services. The Ministry of Works was abolished, only to be subsequently reestablished, and domestic shipping services were resumed again by the Ministry of Transport and Communication. On the revenue side, the private sector strongly opposed a proposal for a value-added tax. Consequently, the tax was not implemented. To support long-term fiscal stability, the PSRP incorporated initiatives to reform management of the social security portfolio, and to establish the Marshall Islands Intergenerational Trust Fund (MIITF). The MIITF was not formally established until 2002, but was eventually implemented successfully.

Efforts to improve the public sector environment focused on restructuring Government, transforming the large public sector, and changing policies that would directly improve the regulatory environment of the private sector. The program to reduce the Government's role in the economy was ambitious. Considerable attention was devoted to improving Air Marshall Islands' performance, but operational and financial management remain weak. A private sector unit was to provide the main force for transforming the SOE sector, but only one enterprise was effectively transformed before the unit was closed on completion of the associated TA. TA support was also provided to reorganize and strengthen the port's authority, and to create an

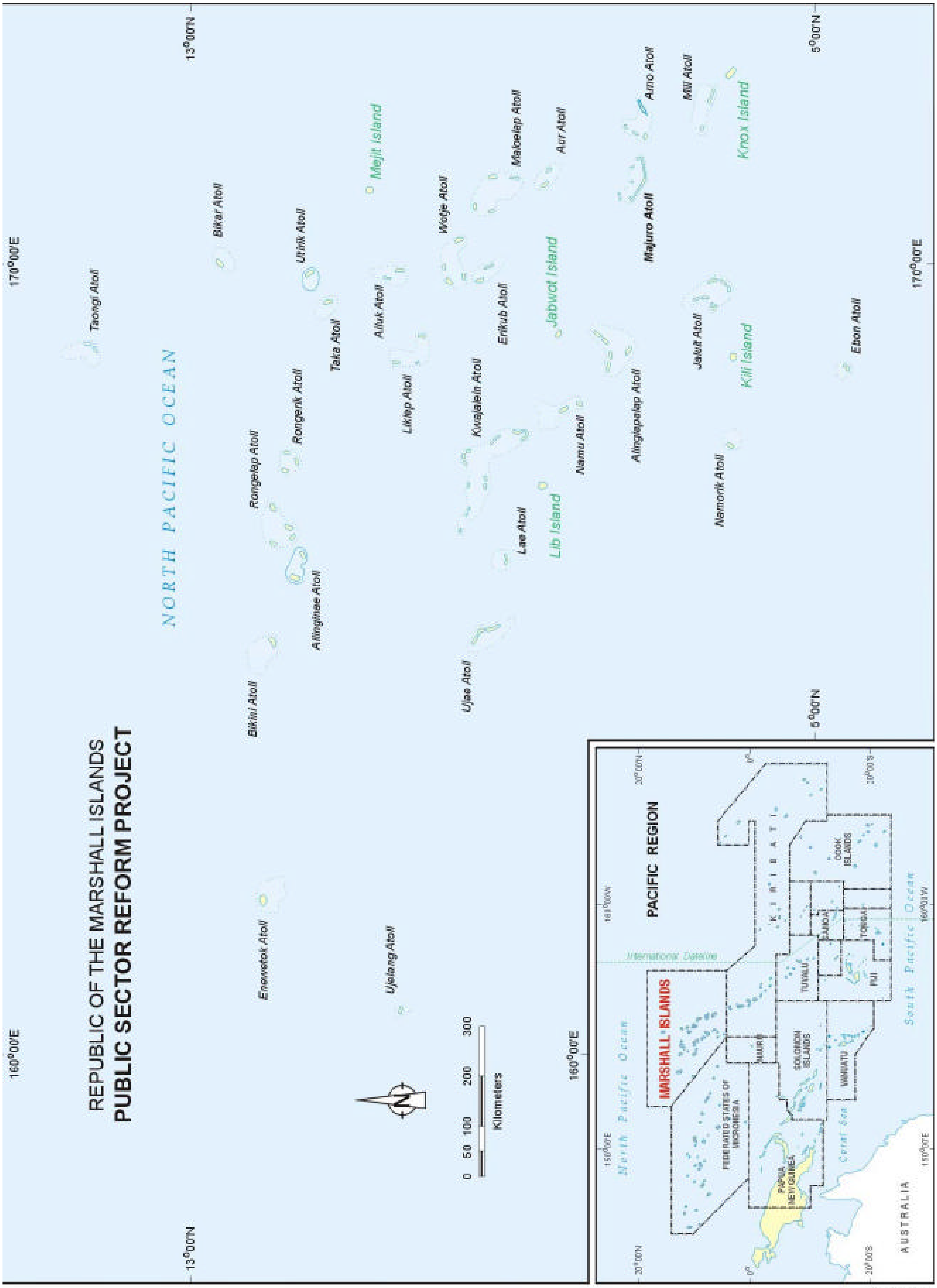
airport authority. Last, program initiatives to rationalize government services were never executed. Policies to improve the regulatory environment of the private sector were more successful, resulting in greater transparency in registration of company and foreign investments. Although efforts to improve land lease security are ongoing, the issue of foreign work permits is still considered a significant constraint to development of the private sector.

The main PSRP goal was macroeconomic: to initiate reform to avert a looming financial and economic crisis in the short term, and to set the economy on a more sustainable growth path in the long term. The Program supported fiscal adjustment in the short term, but failed to stabilize the inevitable crash in the economy in fiscal year (FY) 1995. Gross domestic product (GDP) fell by more than 24% in the next 2 years. Disappointingly, the Program did not reinvigorate the economy, and GDP remained stagnant from FY1997 through FY2001. The impact on real incomes was disastrous, and real per-capita GDP dropped 6.6% from FY1995 to FY2001, ending 22% lower than when the Compact began. The resulting decline in real income during the latter Compact period had a large impact on migration, resulting in a drop in population growth from an annual average of 4.3% to 1.5%.

Evaluation of the PSRP rates the Program's overall design and goals as relevant and consistent with the development strategies of RMI and ADB. But achievement of the Program's purpose is rated as less efficacious. Similarly, the use of program resources and implementation performance is ranked as less efficient. Sustainability is rated as unlikely, and institutional development, moderate. Overall, combining the evaluation criteria, the PSRP is rated as partly successful.

A key lesson from the PSRP—that has emerged time and again in program lending—is that two elements are essential for successful reform: an identified "champion," (or champions), and widespread community support. The PSRP lost its main advocate just before the Board approved the loan, and there was little public consultation during loan design or implementation. Other major lessons learned include (i) the need to match the depth, scope, and timing of the reform program with the government's capacity to implement reforms; (ii) the importance of selecting policy advisory or advocacy consultants based equally on diplomatic skills and technical competency; (iii) the need to temper overly optimistic assumptions of the private sector's ability to replace the Government as the engine of economic growth, in an environment where its size and structure is limited to production of nontraded goods to support a large public sector; and (iv) if program reforms are designed to affect or incorporate fiscal adjustments, then monitoring mechanisms must be in place, or developed, to evaluate overall fiscal performance. This is normally provided through preparation of the fiscal account, consistent with government finance statistics of the International Monetary Fund.

The Operations Evaluation Mission recommended a number of follow-up actions that can be facilitated through technical assistance, and are aimed at consolidating further fiscal reforms as RMI embarks on a new era. Continued expansion in fiscal policy will shortly run into the constraint of declining revenues. Given the built-in reductions in Compact funding over the next 20 years, a long-term budgetary framework should be developed to avoid another major fiscal crisis. Tax reform remains the most important element of fiscal policy. ADB current program assistance includes provisions for tax reform, but this effort must be sustained to not repeat the PSRP experience with the value-added tax. Strengthening of tax administration is the first step in the process. After sustained improvements in tax administration, the issue of tax reform and the introduction of a value-added tax should be reexamined. The external debt position and debt service capacity should also be reviewed, to support development of a long-term fiscal policy.


REPUBLIC OF THE MARSHALL ISLANDS
PUBLIC SECTOR REFORM PROJECT
NORTH PACIFIC OCEAN
Taongi Atoll
Bikar Atoll
Utirik Atoll
Taka Atoll
Mejit Island
Ailuk Atoll
Wotje Atoll
Maloelap Atoll
Aur Atoll
Erikub Atoll
Jabwot Island
Likiep Atoll
Arno Atoll
Majuro Atoll
Mili Atoll
Knox Island
Jaluit Atoll
Kili Island
Ebon Atoll
Ailinglapalap Atoll
Namorik Atoll
Namu Atoll
Kwajalein Atoll
Lae Atoll
Lib Island
Ujae Atoll
Rongerik Atoll
Rongelap Atoll
Ailinginae Atoll
Bikini Atoll
Enewetak Atoll
Ujelang Atoll
Kilometers
0 50 100 200 300
160°00'E
170°00'E
13°00'N
5°00'N
PACIFIC REGION
MARSHALL ISLANDS
International Dateline
KIRIBATI
FEDERATED STATES OF MICRONESIA
NAURU
TUVALU
SOLOMON ISLANDS
VANUATU
FIJI
SAMOA
TONGA
COOK ISLANDS
PAPUA NEW GUINEA
AUSTRALIA
North Pacific Ocean
South Pacific Ocean
Coral Sea
00-2660 RM

I. BACKGROUND

A. The Setting

1. The Republic of the Marshall Islands (RMI) consists of more than 1,000 small islands with a total area of only 181 km^2 dispersed over 2 million km^2 of the Pacific. The population of about 50,000 is concentrated in two main urban centers, Majuro and Ebeye. RMI has a parliamentary system of government, with legislative power vested in the *Nitijela,* or the House of Representatives. RMI has a traditional Council of Chiefs that acts as a consultative body and may request reconsideration of any bill that affects customary law, particularly if it relates to land tenure. The central government is in the capital of Majuro, with 24 local government bodies on populated atolls and islands. RMI's economy has been dominated by the services sector, which contributes as much as 70% of the gross domestic product (GDP). In 1979, RMI signed a Compact of Free Association with the United States (Compact), which became effective in 1986. Annual Compact[1] and other grant payments essentially sustain the GDP. In the mid-1990s, the public sector accounted for about 47% of formal employment, while the remaining 53% essentially serviced the needs of the government apparatus and of civil servants and their families. RMI's economy depended heavily on grants—which distorted the economy.

B. Rationale

2. The generous Compact grant provided assistance to RMI for 15 years, to 2001, extendable to 2003. The aim was to strengthen the economy, with the ultimate objective of economic self-sufficiency. To this end, the Compact funding was designed to decline over the period with two "step-downs" after the 5th and 10th years.[2] By the mid-1990s, RMI faced an uncertain future and had growing problems, including (i) the high level of external transfers had distorted the economy, which had a disproportionately large public sector and a small productive sector; (ii) the second "step-down," coupled with borrowing against future Compact receipts, had created a financial crisis; and (iii) future external assistance from the US or elsewhere after the end of the Compact was uncertain. These concerns made it increasingly apparent that "business as usual" was no longer possible, and that serious economic reforms were inevitable.

C. Formulation

3. In 1995, RMI asked the Asian Development Bank (ADB) to coordinate external support and to provide technical assistance (TA) for economic policy advice. In response, ADB funded a policy advisory team (PAT), which comprised two resident advisers and a number of short-term consultants.[3] The PAT prepared a policy reform program (PRP), which outlined short-term financial adjustments and longer-term structural reforms. The PRP was designed to return the economy to a state of financial stability, and in the longer term, set the country on a more sustainable course for economic growth and development. The Government endorsed the

---

[1] Compact between RMI and the US became effective in 1986. Under the Compact, RMI would receive financial and technical assistance (TA) for 15 years, until October 2001. The total financial assistance was estimated to be $790 million, of which $606 million was to be in regular annual payments.

[2] The annual block grants were $26.1 million for fiscal year (FY) 1987–FY1991, $22.1 million for FY1992–FY1996, and $19.1 million for FY1997–FY2001. All amounts were adjusted for two-thirds of inflation from the base FY of 1981. This provided an adjustment ranging from 22% in FY1987 to 60% in FY2003. The Compact provided for a 2-year transition period from 1 October 2001 in the expectation of protracted negotiations for a possible continuation of US support. The annual payment for these 2 years was set at the average of the preceding 15 years, i.e., the same level as the middle 5-year period. This resulted in significantly increased funds for FY2001 and FY2002—known as "bump-up" funds. A new Compact treaty (Compact II) was signed in May 2003, and should have become effective before the end of 2003.

[3] ADB. 1995. *Technical Assistance to the Republic of the Marshall Islands for a Policy Advisory Team for Economic Management*. Manila.

Program, after long debate in the Nitijela, as the centerpiece of its economic strategy, and presented it at the first consultative group (CG) meeting, hosted by ADB in Manila on 6 December 1995.

4. The immediate needs of financial stabilization required reducing the size and cost of government, increasing revenue efforts, and reducing the costly debt service. In the longer term, public sector restructuring was required to support a more sustainable fiscal position and improvements in the regulatory environment to promote private sector development. To achieve this, the authorities sought an ADB loan to fund compensation costs for staff retrenched under a reduction in force (RIF); retirement of expensive commercial borrowing that was necessary to support Air Marshall Islands (AMI), the national airline carrier; and the establishment of a financial reserve trust fund to support fiscal stability during periods of weak economic performance. An ADB reconnaissance mission visited RMI in May–June 1996, and fact-finding missions followed in May 1996. An appraisal mission was conducted in September 1996. Loan negotiations were conducted in November 1996 and the public sector reform program (PSRP) loan was approved on 30 January 1997. Three TAs were also approved.[4]

D. Objectives and Scope

5. The PSRP goal was to initiate a long-term reform program to avert a looming financial and economic crisis, and to set the economy on a more sustainable growth path. Its four main elements were (i) fiscal stabilization and fiscal policies, (ii) privatization of public enterprises, (iii) public service reform, and (iv) stimulation of private sector development. Three outputs were specified: (i) stabilization of the Government's finances in the short term, (ii) long-term structural stability of the Government's finances, and (iii) creation of an improved environment for the private sector.

6. The scope of PSRP was comprehensive. The policy matrix included 59 conditions: 8 prescribed measures to reduce the number and cost of public service personnel, 5 related to reducing subsidies to public enterprises, 2 related to other cost reductions, and 14 conditions concerned measures to raise revenue. Six conditions related to establishment of sound management of funds under government control, 18 related to the restructuring of government departments and public enterprises, and 6 were designed to improve the regulatory environment for the private sector (Appendix 1 gives the policy matrix).

E. Financing Arrangements

7. A loan from the Asian Development Fund (ADF) of SDR8,241,000 (equivalent to $12 million) was approved in January 1997.[5] The loan funds were to be disbursed over an 18-month period in three tranches of $5.5 million, $3.5 million, and $3.0 million. The first tranche was disbursed on 14 February 1997. The final release was 40 months later, in June 2000. Because of the depreciating value of the SDR against the dollar during this period, actual disbursements totaled $11.3 million. The loan was designed to finance the adjustment costs associated with the reform program—principally, $5.5 million to finance the RIF, $4.0 million to liquidate the high-cost AMI debt, and $2.5 million to establish a Financial Reserve Trust Fund (FRTF). Reported utilization of loan funds as of 30 June 2000 totaled $8.5 million, with only

---

[4] The PRSP was one of seven similar program loans that ADB approved for seven Pacific developing member countries from 1996 to 1998 to address urgent fiscal crises and macroeconomic instability through major structural reforms and policy advisory assistance. The Federated States of Micronesia is particularly similar to RMI in terms of economic ties to the US through the Compact, fiscal problems, and ADB interventions. ADB's Operations Evaluation Department has recently completed project and program performance audit reports for Micronesia and the Cook Islands.

[5] ADF terms at the time of loan approval included a repayment period of 40 years, a grace period of 10 years, and an annual service charge of 1% on disbursed amounts.

about $3.7 million used for the RIF and $0.5 million for the FRTF, but $4.3 million was used to retire AMI's debt.[6]

F. Implementation Arrangements

8. RMI's Ministry of Finance was the Executing Agency for the PSRP loan. The Government's Rationalization Committee coordinated PSRP, and was responsible for its detailed implementation. The chief secretary chaired the committee, with representation from the public service, including the secretary of finance. Although ADB was supporting the Government's capacity for economic policy through the PAT, it was recognized during the Program's design stage that the Government lacked the capacity to implement the necessary reforms. Thus, ADB provided a project coordinator under TA 2755-RMI to support the Rationalization Committee.

G. Program Completion Report

9. The program completion report (PCR)[7] rated the PSRP loan as successful.[8] According to the PCR, although the reform program achieved its aim of stabilizing government finances in the short term, there was little evidence to suggest that the structural problems had diminished. Fiscal policy remained weak, there were no institutional mechanisms to ensure well-informed decisions, and leadership remained unaware of the value of sound financial management. Major reasons for PSRP's mixed results were a lack of participation and consultation, and a lack of understanding of the reasons for the loan. The lack of discussion led to a perception that the reforms were imposed from the outside, despite the fact that the Government had supported the Program after long debate in the Nitijela. Despite these factors, and mixed results of the Program, the PCR concluded that it was generally agreed that the RMI situation had improved considerably over the previous 3 years.

H. Operations Evaluation

10. An Operations Evaluation Mission (OEM) visited RMI in August–September 2003 to evaluate the performance of the PSRP and associated TAs, and conduct a social impact field assessment. The OEM met with current and former staff of the RMI government, representatives of the private sector, nongovernment organizations (NGOs), early retirees under the scheme, and consultants. A draft of the program performance audit report was circulated to the Government and within ADB. Comments were incorporated, when appropriate.

II. IMPLEMENTATION PERFORMANCE

A. Effectiveness of Design

1. Consistency with Government and ADB Strategy

11. ADB's country operational strategy (COS)[9] at the time of the PSRP design was based on a realization that despite the substantial aid that RMI received through the Compact (more than two-thirds of GDP), the nation had failed to establish a growing or even self-sustaining economy. RMI faced an unsustainable macroeconomic situation, and a realization that Compact

---

[6] Documentation of the actual utilization of the $11.3 million loan proceeds could not be located.
[7] ADB. 2000. *Program Completion Report for the Public Sector Reform Program in the Republic of the Marshall Islands*. Manila.
[8] Based on the four-category rating scale of unsuccessful, partly successful, successful, or highly successful.
[9] ADB. 1994. *Country Operational Strategy for the Republic of the Marshall Islands*. Manila.

funding might not be renewed, or might be reduced sharply, after expiration of the current provisions in fiscal year (FY) 2001.

12. The COS identified a unique role for ADB, which would constitute a guiding framework for governing assistance to RMI over the medium term. The strategy combined (i) a leadership role in providing policy advice through provision of the PAT team, (ii) special emphasis on coordination with development partners, (iii) support for structural adjustment, and (iv) continued assistance for project finance and TA. Although special emphasis on coordination with development partners was to be through a series of CG meetings, the PAT team was to support structural adjustment aimed at sustainable development, potentially through program loans, considering the looming financial crisis.

13. Although ADB had identified serious macroeconomic and fiscal imbalances, the Government had already recognized that improvement of public sector management was a key issue. The President established the Rationalization Committee to thoroughly review the public services, and to identify short- and medium-term measures to enhance both the economy and the efficiency of public services. The World Bank and United Nations Development Programme (UNDP) were requested to provide TAs. Their final report outlined six major problems: (i) an overstaffed public service sector, (ii) inefficient delivery of public services, (iii) many nonproductive workers, (iv) a serious shortage of technically qualified workers, (v) weak organizational structures, and (vi) widespread functional duplication. In the FY1995 budget, the Government introduced a wage freeze, a significant cut in wage expenditures by reducing the working week to 4.5 days, and an increase in revenues—even though a $7 million deficit was projected, and the early retirement program was not implemented. The PSRP design was, thus, consistent with both ADB's and the Government's strategies at the time.

2. Adequacy of the PSRP Preparation

14. The preparation of the PSRP was a derivative and extension of the PRP prepared by the PAT team, which thus obviated the need for a separate project preparatory TA. The PRP established an overall framework for policy reform to assist RMI, and had been presented in December 1995 to a CG of donors that met in Manila, hosted by ADB. The PSRP drew further on a Public Sector Management Improvement Program (PSMIP) developed by UNDP in 1995. The PSMIP provided the basis for public sector rationalization and the underpinning for the downsizing of the public service sector through the RIF. Thus, the basic building blocks for the PSRP were on hand, and the program design had the advantage of drawing on the analysis and resources of consultants who were well acquainted with RMI conditions.

15. However, the lack of ownership of the Program established during preparation was to be a major impediment during implementation. OEM discussions with Marshallese indicated minimal participation or consultation with the community during program preparation concerning the need for, or shape of, the PSRP.[10] The late President Amata Kabua was the main "champion" of PSRP, and took the Program through the Cabinet and Nitijela in the early stages. The PAT team developed a well-structured program, but failed to gain confidence of the RMI leadership, so was ineffective in communicating the needs to the community at large.

3. Coherence, Logic, and Sufficiency of the Program

16. Although the looming fiscal crisis and stabilizing of government finances were the PSRP's most pressing short-term concerns, the Program placed greater emphasis on ensuring the long-run stability of government finances, and improvements in the environment for private

[10] Even though the report and recommendation of the President (RRP) (para. 102) states, "Extensive discussions and widespread consultations have sought to broaden the support for the PRSP."

sector development. There were 14 loan conditions to help stabilize the ongoing fiscal crisis, 24 loan conditions to support long-run fiscal stabilization, and 21 conditions to support private sector development. While recognizing the political difficulties of painful short-term adjustment policies, the Program's design limited itself to greater revenue effort in only one of the three main taxes, and only a relatively small reduction in expenditures. Furthermore, the Program provided no targets or indicators to monitor the impact of policies on the fiscal position such as the government financial statistics (GFS) of the International Monetary Fund. Regarding the policies associated with longer-term fiscal stabilization, the Program was well-designed and coherent. In terms of developing the environment for the private sector, the program design emphasized reform of the state-owned enterprise (SOE) sector, with a limited range of conditions relating to the private sector regulatory environment.

17. The standard approach to economic restructuring to encourage a shift in resources from one sector to another—in this case, from the public to the private sector—is to encourage a shift in the relative price of labor, or the wage differential between the public and private sectors. The PSRP was consistent with this approach by freezing public sector wages, although no explicit policy was initiated to reduce public wages. In an economy with no independent exchange rate, and with freedom of labor to migrate, the potential to reduce the real wage, either directly or indirectly, is severely inhibited. The PSRP notionally focused on policies to reduce real wages over time, to halt adverse movements between the private and public sectors, and to reduce structural impediments to private sector development by improving the regulatory environment.

18. A major omission in the Program's design was an apparent lack of any transition support for retraining displaced public servants for jobs in the private sector, or providing courses for public servants to start small businesses.[11] Although the potential for establishing new private sector businesses during a period of reduced economic activity may have been limited, the Program's failure to provide any counseling services, a normal component of the standard structural adjustment program, is surprising. Furthermore, the Program included no provision to monitor the social impact of the reforms on displaced public servants, their families, or the population in general.[12]

4. Identification of Assumptions and Risks

19. During design, three major risks were identified that could negatively affect achievement of the PSRP's purpose: (i) the Government's capacity to implement the reforms might be insufficient; (ii) the Government's commitment to the current pace of reform might not continue, because retrenchment of a large number of civil servants might fuel strong opposition to reforms; and (iii) the private sector might not respond as expected. Three supplementary TAs were provided to help with the Government's capacity to implement the reforms. The first TA was to support overall program implementation, while the other two were to support reforms in transformation of SOEs, and reforms in the transport sector. The two complementary TAs may have been a necessary condition for successful program execution, but they were insufficient. The structure of the large SOE sector remains largely unchanged and, although new regulatory authorities were created in the transport sector, activities such as domestic shipping remain as

[11] Para. 81 of the RRP states that "…counseling and training to be provided under the PRSP would assist those affected in seeking alternative employment and, by doing so, serve to absorb the unemployed and rekindle national recovery." Also, a UNDP Sustainable Livelihoods Development project, approved in February 1998, for $252,750, was aimed to build and strengthen the capacity of local communities to mobilize resources and expertise in order to generate income and livelihood opportunities for disadvantaged people living in the outer islands or urban centers. OEM discussions did not indicate any significant impact from this Program, or local knowledge of it. Knowledge of the Program seems to have been too little, and too late.

[12] Para. 90 of the RRP indicated that the Office of Planning and Statistics would monitor the social and economic impact of the PRSP through a system to be developed with TA from UNDP. But the OEM found no evidence of this assistance.

inefficient as at the time of program preparation. Furthermore, although substantial supporting TA was provided, the Government clearly lacked the capacity to implement the envisaged strengthening in tax administrative, tax reform, or public sector rationalization.

20. The second risk identified in para. 19 also became a major constraint to effective implementation. Commitment to the reforms dissipated with a lack of participation during program design, and the late 1996 death of President Kabua, the Program's main champion in its earlier stages. The new President and administration, while publicly endorsing the reforms, harbored serious concerns about the need for the PSRP. With the run up to the elections in November 1999, the reforms either went on hold (i.e., implementation of the RIF did not begin) or were reversed (i.e., the increases in import tax rates). Fortuitously, a new President and administration took office in January 2000, which supported the Program and renewed commitment to the reforms. That enabled final achievement of many program covenants, although after delays.

21. The third risk identified in para. 19 also eventuated and was not successfully mitigated—the failure of the private sector to replace the level of economic activity generated by the public sector. In the short term, the substantial reduction in government expenditure led to a significant downturn in demand for the production of domestic services. This, in turn, adversely affected the private sector's ability to maintain employment levels, let alone provide new jobs for the displaced public servants. In the medium- to longer-term, the task of restructuring or developing private sector activity in the production of traded goods for export proved impossible. The private sector was unable to respond, and failed to provide alternate sources of employment for either the displaced government employees or the growing labor force. Instead, the mounting pressure of growing unemployment led to substantial migration to the US, which was made possible through the liberal immigration provisions under the Compact.

22. An important assumption underlying the PSRP design was that US funding to RMI would be substantially reduced or even terminated with expiration of the Compact's original economic provisions. Although many officials believed that the coming renegotiations would maintain transfers at current levels, the PSRP design went further than simply providing an adjustment strategy to the reduction in grants with the second step-down. Implicitly, the PSRP provided a strategy for long-term fiscal adjustment and accelerated growth of the private sector to compensate for any reduction in the amended Compact provisions. In the event the reduction in transfers renegotiated was not large, and when coupled with the receipt of annual grants from Taipei,China, no significant adjustment was required.

B. Policy Reform Measures

1. Stabilize Government Finances in the Short Term

a. Increase Revenues

23. The PSRP incorporated three mechanisms to increase the collection of tax revenues: increases in tax rates, removal of exemptions, and administrative strengthening. To improve the Government's weak fiscal position by increasing tax revenues, the import tax regime was simplified and the basic rate increased from 10% to 12% in March 1996, almost a year before loan effectiveness. Rates on alcohol and tobacco were switched from a specific basis and increased to 150% of the cost, insurance, and freight (CIF) import value. But these rates would not remain in force for long, and in the run up to the 1999 election, the general import duty rate was reduced to 5% of the CIF value, cigarette duties were reduced to 50%, and duty on alcohol was set at 25 cents a can for beer, and $2.50 per gallon for wine. With installation of a new

administration in January 2000, and continuing fiscal problems, the general rate was once again increased to 8% in October 2000, which remained in effect to the time of the OEM.

24. The 1996 introduction of tax increases was reflected in a 22% increase in import tax revenues in FY1997. But the subsequent lack of commitment to tax effort, and the October 2000 imposition of a regime at an effective rate lower than that before introduction of the reforms, resulted in a collection level little different than the FY1996 level. The reform initiative to increase tax revenues focused on import duties, a tax base that represents only 30% of total tax collection. But throughout the Program and until now, the other major taxes—income taxes and the gross receipts tax—have been a more stable source of government revenue, and have not been subject to political manipulation. At the time of program closeout, the objective of increasing revenues had clearly failed. Only at the time of the OEM had the level of tax effort even returned to pre-reform levels.

25. The removal of exemptions was a major element in improvement of the tax system. No changes in exemptions were introduced during the PSRP, despite the February 2002 repeal of section 207 of the Import Duties Act, which provided exemptions for a wide range of private sector activities including hotels, tourism establishments, manufacturing, and fishing. But public sector institutions—SOEs, NGOs, churches, and schools—all retain import duty exemptions. Furthermore, a large range of activities and SOEs remain exempt from the gross receipts tax (GRT), although removal of GRT exemptions was an important loan condition. Thus, there has been some extension in broadening the tax base, but considerable scope for improvement remains.

26. The reform program also emphasized strengthening of tax administration, through the appointment of a tax auditor to assess arrears, and the appointment of two expatriates, one as chief of taxation and revenue and the second, as head of customs. The Australian government recruited both advisers on 2-year contracts. But these initiatives do not appear to have had any sustained impact on improved tax administration. The current administration has 10 staff in customs, and 4 in tax and revenue, with staff in both divisions covering for one another as the workload requires, and an inadequate foundation to provide the basis for a modern tax collection system.[13] Thus, tax administration remains weak, with inadequate staff, training, equipment, and resources, illustrating the formidable challenges to building capacity within RMI.

b. Reduce Expenditure

27. The effort to reduce government expenditures focused on reducing the level of SOE subsidies, a 3% reduction in total government operating expenses initiated in FY1996 before loan effectiveness, and containing wage costs by eliminating civil service vacancies and introducing a freeze on hiring. Major PSRP emphasis was on reducing and eliminating subsidies to SOEs. Subsidies to the Marshall Energy Company (MEC) and the Majuro Water and Sewer Company (MWSC) were to be eliminated, while operating subsidies to Tobolar, the copra export company, and AMI were to be reduced by 25% of FY1996 appropriations. The table below shows the level of transfers to the SOE sector from FY1993 through FY2002. Although the PSRP targets were achieved with respect to AMI, MEC, and MWSC (except in FY1997), the target reduction in transfers to Tobolar were unrealistic. Tobolar provides a major function in collection of copra from the outer islands, in income support for disadvantaged households, and in overseas exports. With international copra prices remaining low, and high domestic shipping costs within RMI, the Government has little alternative but to subsidize Tobolar if it wishes to maintain outer island incomes. Given the desire to reduce poverty and support outer island

[13] The OEM received numerous complaints about the lack of a level playing field in tax imposition, and serious smuggling problems, but establishment of their validity was not possible.

incomes, the PSRP objective of reducing copra subsidies to decrease government expenditures may not have been well conceived.

Table 1: Subsidies to State-Owned Enterprises
($ million)

(Fiscal Year)

State-Owned Enterprise	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Tobolar	1.9	2.2	2.7	0.6	0.5	0.6	0.6	0.8	3.1	1.4
Marshalls Energy Company	0.4	1.3	0.0	0.0	0.6	0.0	0.0	0.0	0.0	1.9
Air Marshall Islands	3.7	5.3	2.7	1.5	0.3	0.5	1.9	2.0	0.0	1.5
Majuro Water and Sewer Company	0.3	0.2	0.5	0.0	0.1	0.0	0.0	0.1	1.0	0.8
Others[a]	0.5	1.1	0.8	0.5	1.3	1.8	1.2	3.3	2.2	1.1
Total	**6.8**	**10.1**	**6.7**	**2.6**	**2.8**	**2.9**	**3.7**	**6.2**	**6.3**	**6.7**

[a] Others include National Telecommunications Authority, Kwajalein Atoll Joint Utilities Resources, Marshall Islands Development Bank, Majuro Resort, Marshall Islands Visitors Authority, Marshall Islands Ports Authority, and Marshall Islands Airports Authority.
Source: International Monetary Fund and Operations Evaluation Mission update for FY2001 and FY2002.

28. Adjusting for subsidies to AMI, which represent transfers of PSRP counterpart funds to retire commercial debt, the effort to contain the subsidy levels to SOEs was successful during the PSRP compared with FY1993–FY1995. But subsidies began to rise afterward, as additional funding became available,[14] and now amount to almost pre-program FY1995 levels. The efforts to contain wage costs by implementing a wage freeze remain in force today, and the RIF had a significant impact on reducing wage costs. Thus, the overall impact of the PSRP on reducing expenditures in the short term was significant (Appendix 2, Table A2.1). Expenditures fell in each successive year from FY1995 through FY1999. But although wage restraints remained in force during FY2000, upward pressure began to emerge as current expenditures rose to $58.2 million, reflecting a large increase in outlays on goods and services, subsidies, and transfers.

2. Ensure Long-Term Structural Stability of Government Finances

a. Reduce Recurrent Expenditures by At Least 20% During the Program

29. The PSRP provided three main vehicles of reform to sustain a long-term reduction of recurrent expenditures: a reduction in the number of government employees through RIF, restructuring of government operations, and maintaining the civil service wage freeze. Figures on the size and composition of the civil service before the implementation of the PSRP are imprecise. But by the time of loan effectiveness, the Government employed an estimated 1,944[15] civil servants. The PSRP required a reduction of 460 employees, or 24%, to reach a target level of 1,484. The RIF was to be achieved by individual ministries, with each given a

[14] Due to repayment of bond issues secured against compact flows, and as additional resources became available from new grants from Taipei,China.
[15] A report prepared by the PAT team in October 1996, *Policy Reform Program: A Time-Bound Action Plan*, estimated public service employment of 2,303. The OEM estimate of 1,944 is based on deducting 178 vacant positions, and 181 cooks employed under a US federal program that was terminated before PSRP effectiveness.

target.[16] In order to mitigate the impact, the Government provided a compensation package based on (i) a lump-sum equivalent of 3 months salary, and (ii) half a month's salary for each year of service up to a maximum of 18 years. A modified formula was applied to employees aged 50 and over, and a cap of $20,000 was applied.

30. Achievement of the targets proved difficult and the time line appears to have been overly optimistic. In the progress report presented to the Board for the second tranche release, the number of civil servants had fallen to 1,690 by February 1998, about 200 short of the target. Difficulties in attaining the target delayed the second tranche release. The Board then deferred the requirement until the third tranche, to maintain the reform momentum. By June 2000, the target had been achieved, which paved the way for release of the third and final tranche.

31. A major component in the attempt to reduce long-term expenditures was restructuring of certain government ministries and functions. The functions of the Ministry of Social Services were to be merged with those of the Ministry of Interior, and the Ministry of Public Works was to be merged with the Ministry of Resources and Development. The closure of the Ministry of Social Services followed termination of the US federal hot lunch program. The construction and maintenance programs of the Ministry of Public Works were privatized. Furthermore, the Marshall Islands Shipping Corporation was closed, and its functions privatized. The reduction in government ministries from 10 to 8, and the restructuring, resulted in significant payroll reductions.

32. The gains achieved through restructuring were short-lived. Resources and institutional arrangements were inadequate for the private sector to successfully provide needed services in construction, road maintenance, and domestic shipping. Resources were not budgeted for some services such as road maintenance. Subsidies were insufficient for the private sector to profitably deliver costly outer island shipping services. After the reforms, road maintenance either deteriorated or ceased, and outer island shipping services became inadequate or prohibitively costly. Consequently, the newly elected Government recreated the Ministry of Works and again commenced domestic shipping services, in competition with the private sector, through the Ministry of Transport and Communications. Both decisions involved political considerations, but it also appears that planning and institutional development were inadequate to establish the regulatory capacity to develop an attractive environment for the private sector to deliver the services needed.

33. Although the target level of civil servants was attained, numbers have since risen rapidly (Appendix 2, Table A2.2). The reestablishment of the Ministry of Public Works, and commencement again of domestic shipping, have added significantly to payroll costs. Furthermore, there have been significant increases and rehiring in both the ministries of health and education. Although the original target was a 24% reduction in public servants, the current attainment is only 4%. Although the gains from the RIF have largely been eroded, the freeze on wages has remained in force since its introduction in March 1996, although step-increases have been awarded. Combining these factors, the current wage bill in FY2003 is estimated at $23.7 million—$1.8 million, or 8% higher than in FY1995, before PSRP began.

---

[16] The OEM spent considerable efforts to establish the rationale—but could not establish the basis—for the overall and individual ministry targets. Ministries repeatedly told the OEM that they did not understand the logic behind the targets, and that the targets were imposed without consultation. It is understood that the logic behind the RIF was outlined in the PSMIP that UNDP developed in 1995. But the OEM could not obtain full documentation of the study so thus, could not comment on its suitability. The PAT team in PRP indicated that the original intention was to implement the RIF over 5 years and, although reductions were expected in health and education, these were to be through cuts in administration rather than in front-line services. Regardless of the underlying rationale, the RIF was implemented with inadequate discussion, and with the appearance of being imposed, with inadequate justification.

34. Although both payroll costs and current expenditures were reduced in the short term (Appendix 2, Table A2.1), both payroll and expenditures have grown substantially in the long term and since closure of the PSRP. Expenditures dropped to $48.4 million in FY1999, at the lowest point of the cycle and during the reforms. But expenditures then rose rapidly, to $65.5 million in FY2002. Expenditures from FY1995 through FY2002 rose at an average annual rate of 2%, but have largely remained stagnant in real terms. Although the PSRP target of 20% reduction in expenditures was achieved during the program period, it clearly was not maintained either in the short or long terms.

b. Improve and Broaden Domestic Revenue Collection

35. Long-term reforms to strengthen domestic revenue collection included tax reform, administrative strengthening, and introduction of road user charges. The main strategy of tax reform was the introduction of a value-added tax (VAT), changes in the income tax regime, and imposition of a tax on rental income. The proposal to introduce VAT was a major cornerstone of the PAT team's PRP. But even though VAT would be a desirable element of tax reform in RMI, and would enable replacement of the inefficient and cascading GRT, the proposal apparently met with considerable hostility and was never implemented.[17]

36. The Board waived a PSRP requirement to introduce a tax on rental incomes, a third tranche release condition, on the understanding that it would have unnecessarily complicated the tax system, resulted in double taxation, and would have generated only limited additional revenue. Nor were reforms to revise road user charges acted upon. In summary, efforts to strengthen the long-run stability of government finances through tax administrative strengthening and reform were not effective.

c. Establish Sound Management of Government Trust Funds

37. Policies to improve and establish sound management of government trust funds included actions to improve administration of the Marshall Islands Social Security Administration (MISSA), establishment of FRTF, and establishment of a Road Users Trust Fund. After a period of weak management and political interference in the board and operations of MISSA, a new board and administration were appointed in 2000 after the 1999 elections and new political leadership came into power. MISSA now seems to be managed soundly, although there is scope for further diversification and sophistication in the financial management of its portfolio.

38. The original intention of FRTF, a second tranche release condition, was to establish a buffer fund to support financial stability during periods of weak economic performance. Loan resources of $2.5 million were devoted to this purpose. But during program execution, it was decided to establish a Marshall Islands Intergenerational Trust Fund (MIITF), which was designed to provide a secure source of revenue for future generations without depletion of its real capital. MIITF was to receive special Compact contributions beginning in FY2004, after completion of the present negotiations with the US. After a 20-year buildup period, the MIITF would provide sufficient yield to replace the annual Compact transfers.

39. The law creating MIITF was enacted in March 1999, although the fund was not formally established until 2002. The PSRP counterpart funds were eventually transferred to MIITF, and have been subsequently augmented by substantial contributions from the Government and the

[17] Before contemplation of a VAT, considerable improvements to the existing administrative capacity would be required. The PSRP proposed a study on reorganization of the Revenue Division. The study was reported as having been completed, but it was unknown to the existing tax administration.

ADB-financed Fiscal and Financial Management Program (FFMP) loan.[18] It is understood that the fund resources, now $32 million, will be transferred to the Compact Trust Fund after the US Senate and the RMI Government have ratified the amended Compact. Although the PSPR resources have been allocated to a purpose different than originally intended, the MIITF has provided a suitable vehicle for investment of budget surpluses during the Compact buildup years of FY2002 and FY2003.

40. A Road Users Trust Fund was required as a third tranche condition, and was apparently established under law in March 1999. But no resources were ever appropriated, and this trust fund is effectively defunct.

3. Improve the Environment for the Private Sector

a. Reduce Government's Role in the Economy

41. The reform program placed considerable emphasis on enabling private sector development by reducing the Government's role, both through rationalizing the structure of the Government itself, and through reducing the role of Government in providing services that the private sector could provide more efficiently. This section of the PSRP policy matrix contained the largest number of covenants of all program areas. The areas of focus were reform of AMI, establishment of a private sector unit (PSU) to guide SOE transformation, implementation of the UNDP PSMIP recommendations, creation of corporations for airport administration and tourism development, and continued emphasis on private sector operation of domestic shipping services. A study was also intended to review wage differences between the public and private sectors.

42. A major concern at the time of PSRP design was the mismanagement and financial cost of operating AMI. Operational costs of maintaining a fleet of modern airplanes, including a DC-8, and political involvement in daily operations had resulted in a deteriorating financial position with serious consequences for the Government's fiscal position. Reflecting the threat that AMI's financial position posed to financial stability of the Government itself, $4.4 million of the program counterpart funds were used to retire the airline's expensive commercial debt. A major PSRP objective was to place AMI on a more secure and sustainable operational and financial basis, although this did not require outright privatization. The PSRP required appointment of a professional and experienced chief executive officer; giving AMI management clear, delegated powers and resources; reducing the AMI board size to five members, two of which would represent the private sector; reducing staffing levels; and using least-cost methods to terminate the DC-8 service.

43. Although AMI management has improved, much remains to be done. Three of the original aircraft have been sold, services have been limited to domestic routes, and the staff has been reduced from more than 200 to 78. Those measures have significantly improved AMI's financial position. After a period of significant turnover in AMI managers, the current manager has held the position for 3 years. The manager has extensive experience in aircraft operations, but not in airline finance, so the airline is looking for a chief financial officer. The airline board has been reduced to six members, with three from the private sector. All board members seem to be engaged, and genuinely interested, in making AMI operations financially viable. But the airline has not been provided sufficient resources to purchase parts, nor the working capital to establish a sustainable service for the new Dash-7 aircraft. Furthermore, the airline has neither clearly delegated powers, nor independence from the Government. In summary, although the

[18] ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grant to the Republic of the Marshall Islands for the Fiscal and Financial Management Program*. Manila.

threat posed to the Government's financial position has been reduced, AMI's operations and finances remain fragile, and the airline has not yet established a professional management capacity, nor developed viable and sustainable services.

44. The establishment of a PSU, with assistance from TA 2757-RMI, was to provide support for transformation and privatization of SOEs, and to develop a preliminary framework for private sector regulation. A second tranche condition required the PSU to be established in the Office of the President for a period of no longer than 2 years. The PSU was established, and reviewed nine SOEs: AMI, domestic shipping, MWSC, MEC, the National Telecommunications Authority, Kwajelein Atoll Joint Utilities Resources (KAJUR), Tobolar, the Outrigger Hotel, and the Marshall Islands Drydock. KAJUR was the only entity to be successfully transformed by the PSU, which was contracted out to private sector management in 2000. In a step backward, after completion of the present contract, it is understood that KAJUR will be transformed into a government-owned corporation, but managed by staff of the existing private sector contractor. The Domestic Shipping Corporation was abolished, and private sector contractors assumed its services. But the Ministry of Transport and Communication subsequently bought three boats, using aid funds from Taipei,China, and reestablished operations in competition with the single remaining private sector operator. MWSC and MEC are SOEs, while the National Telecommunications Authority is a majority-owned government corporation. Tobolar, the Outrigger Hotel, and the Marshall Islands Drydock are all managed by the private sector. The PSU was not institutionalized, and was disbanded on termination of the TA.[19] Furthermore, the recommended framework for private sector regulation was not adopted. The Government has yet to clearly see the benefits from transformation and privatization of the large SOE sector. Progress has been painfully slow, and has often been reversed. Consequently, the Government continues to provide significant subsidies to fund the sector (Table 1).

45. Major contributions to improving the environment for private sector development were envisaged through efforts such as rationalizing the public service, clearly defining public service functions, establishing terms of reference for ministries, setting staffing requirements, improving management methods, and developing new job descriptions. The framework was the UNDP PSMIP, which was required under the PSRP to be transformed into a detailed action plan and to be subsequently implemented. While the PSMIP was utilized as a source document in the PSRP design, which included the RIF outline and proposed reduction in the number of ministries from 10 to 6, the OEM found no evidence to suggest that the wider rationalization of the public service was ever undertaken. Indeed, a major criticism of the RIF was that it was arbitrary, and not based on any rationalization program. Currently, an ADB TA is under implementation to address many of the original PSMIP objectives (footnote 18).

46. Two conditions for release of the third tranche related to the establishment of a cost-efficient and self-financing Marshall Islands Airport Authority (MIAA), and transfer to it of all airport regulatory functions. The MIAA was created through legislation in 1999. Its board originally comprised the secretary of Transport and Communications, the director of Civil Aviation, and three members from the private sector. The board elected the chairperson, and the new Authority had powers to set airport and landing fees. Two subsequent amendments to the law were enacted to change the board's composition, and to subject the Authority to the Administrative Procedures Act. The first amendment established the secretary of Transport and Communications as chairperson, and required that only one member be from the private sector. The second amendment took away powers of the board to set fees, and subjected any changes to cabinet approval. MIAA revenues are generated from landing fees, departure fees, and rent of airport facilities. The Government pays rent for the airport, estimated at more than $400,000 annually, to the landowners directly. MWSC pays no fee for the water catchments, which are an

[19] Support for a second phase of the PSU is on standby for inclusion in 2003 under the 2002 Country Strategy Program, but is otherwise slated for 2004.

important water source for the Majuro water reservoir. Furthermore, AMI is exempt from paying airport landing charges. Not surprisingly, MIAA has not achieved the objective of being self-financing, and is a good example of the interrelated nature and political environment in which SOEs exist in RMI.

47. The PSRP was responsible for the 1997 operationalization of the Marshall Islands Visitor's Authority (MIVA), established to promote the development of niche market tourism. The creation of MIVA was also supported through an ADB TA,[20] whose objectives were to (i) help institutionalize the nascent MIVA, (ii) identify and develop key tourist-generating markets, and (iii) outline a preliminary tourism development strategy. MIVA is small, with a seven-member board; five are from the private sector. The Government provides MIVA an annual grant of about $300,000. Government support was originally intended to be phased out over 3 years, then MIVA would generate its own revenue. Funding was to have been provided through a 1% allocation from the 8% hotel room tax, $5 of the $20 MIAA departure tax, and $1 of the $3 Majuro local government room tax. But none of the bodies responsible for these taxes were prepared to support MIVA, so the government subsidy continues to provide the vast majority of MIVA's funding. With limited funding, and the need to support the office and staff, resources to promote tourism are limited.

b. Improve the Regulatory Environment

48. Although the PSRP provided a comprehensive set of reforms affecting the public sector, actions to directly improve the environment for private sector development were limited to 6 of the 59 PSRP policy conditions. The PSRP was thus primarily intended as a vehicle to improve the efficiency of the public sector, with a limited range of policies designed to assist private sector development. Policy reforms in the program included changes to improve transparency in company registration, issuing of work permits, the foreign direct investment regime, and legislation to ensure security in land leases.

49. Before the PSRP, the Cabinet issued company registration and foreign investment licenses in a manner considered to lack transparency. In March 2000, the Corporate Administration Act was amended to fulfill a third tranche condition, creating a registrar of companies for resident domestic and authorized foreign corporations delegating responsibility to the Attorney General's office. A registrar was also created for nonresident companies, which delegated responsibility to the Trust Company of the Marshall Islands. Changes were made to the Foreign Business License Act transferring licensing authority from Cabinet to the Attorney General's office. A list of activities prohibited for foreign investment was issued. Both company and foreign investment permits are now issued in a manner that the private sector generally considers transparent, although often they are not processed promptly. The program included a condition for the Government to protect foreign investment by applying for membership in the Multilateral Investment Guarantee Agency and International Center for Settlement Disputes, but that condition was not complied with.

50. The PSRP also provided for review and subsequent enactment of policies to make the issue of foreign work rapid and transparent. But the private sector has strongly criticized the issue of foreign work permits, which is administered under the Protection of Resident Workers Act, as being burdensome and subject to long delays, constraining the efficient conduct of business. The PSRP also included a condition for enactment of legislation to guarantee the security of land leases. The Nitijela approved the Marshall Islands Development Land Registration and Authority Act in 2001, but did not provide adequate guarantees. Ongoing TA[21]

[20] ADB. 1995. *Technical Assistance to the Marshall Islands for the Tourism Development*. Manila.
[21] ADB. 2002. *Technical Assistance to the Republic of the Marshall Islands for Mobilizing Land*. Manila.

support is assisting the Government in preparing new land registration legislation, to be implemented voluntarily, and to operationalize the Land Registration Authority.

51. The PSRP was restricted in scope in policy measures to be implemented to encourage private sector development. Despite some success in developing a more transparent regime, the environment for private sector development remains weak, with minimal direct program impact. The issue of work permits is a serious obstacle to business development. The Foreign Direct Investment regime needs review and conformity with best practices,[22] and secure land leasing is yet to be implemented and accepted by the community. The considerable distrust between the private and public sectors was voiced to the OEM in numerous meetings. Policies to protect land and domestic labor, and the continued government involvement in the large public enterprise sector, indicates that the Government has yet to endorse a model of private sector development.

C. Effectiveness of Technical Assistance

1. TA 2755-RMI: Rationalization Committee for a Program Coordinator

52. Because of the perceived lack of implementation capacity to execute the PSRP, an associated TA was designed to assist effective execution. The scope of the TA included establishment of technical support for the Rationalization Committee; design of detailed implementation plans, including responsibilities; coordination among the various ministries and agencies; and progress reporting. The TA was efficiently executed and rated as successful.

2. TA 2756-RMI: Institutional Strengthening in the Transport Sector

53. Reform of the transport sector was identified as an area of special importance in the PSRP. The scope of the TA was to reduce transport costs and improve the quality of service by commercializing transport operations with respect to port and airport operations, and improving cost recovery and maintenance funding of roads. The TA supported reform and strengthening of the Marshall Islands Ports Authority (MIPA), and the successful creation of MIAA. MIPA is self-financing, but MIAA remains dependent on government financial support. The Government created a Roads Trust Fund, but no resources were allocated. The TA is rated as partly successful.

3. TA 2757-RMI: Support of the Private Sector Unit

54. Considering the Government's substantial involvement in the economy, the PSRP included support for an associated TA to assist the Government in transformation of the large SOE sector, through the creation of a PSU for 2 years. The PSU objectives were to assist the Government (i) to privatize, in whatever form, its agencies and corporations; and (ii) to develop a preliminary framework for private sector regulation. The PSU was established, and successfully contracted out KAJUR, the Kwajalein utilities corporation, to private sector management. The TA reviewed operation of the SOE sector and prepared a regulatory framework for privatized public enterprises. But political commitment to SOE reform was weak, and the PSU was dissolved on completion of the TA, despite the large uncompleted program and obvious need for continued reform. The TA is rated as partly successful.

[22] The Government has requested the Foreign Investment Advisory Service for assistance in analyzing and evaluating foreign investment practices.

4. Related Technical Assistance—TA 2295-RMI: Policy Advisory Team for Economic Management

55. The identification, need, and design of the PSRP were largely developed from the work of the PAT team. The team prepared an original PRP, which was presented to a CG meeting in Manila in December 1995 and provided the basis of the subsequent request to ADB for the PSRP loan. The PAT team prepared a wide range of policy papers, including a PRP time-bound action plan; and papers on tax reform and advocacy of VAT, trade policy, labor market and private sector development, infrastructure development, privatization prospects, access to land by investors, and social issues; and an organizational analysis of the Ministry of Education. The PSRP policy matrix was integrated with, and benefited from, a set of well-constructed and prepared papers.

56. Although the PSRP was based on a solid analytical framework, the PAT team failed to gain the Government's confidence, or to advocate the Program to the public. There was a lack of participatory meetings, including summits, to explain the prevailing economic situation and need for the reforms. The view presented to the OEM was that the rationale for the PSRP was not communicated well to the affected agencies, and was applied in an ad hoc manner. In early stages of the process, the PSRP benefited from championship of the RMI President. But support dissipated after his death, and the new administration was not reform-minded. As the political environment for the PAT team became unfavorable, and the team became marginalized, there was a conspicuous lack of support from potential reform advocates. Even at the time of the OEM, several years after program completion, no desire for renewed policy advisory support was expressed, despite an obvious vacuum and need for economic policy formulation and advocacy.

III. PROGRAM OUTCOMES

A. Macroeconomic Impact

57. The main PSRP goal was macroeconomic in nature: to initiate a reform program to avert a looming financial and economic crisis in the short term, and to set the economy on a more sustainable growth path in the longer term. The absence of detailed national accounts in RMI makes assessment of the PSRP's impact on the economy difficult. The national account series has not been updated since 2001, and the industrial classification used makes estimation of the impact of the reforms between the private and public sectors impossible. During the first phase of the Compact (1987–1995), before the second step-down, the economy is estimated to have grown by an average annual rate of 4.4% (Appendix 2, Figure A2.1). During this phase, the economy adjusted to large increases in Compact flows and external borrowing financed through bond issues secured against future Compact receipts. Economic growth was rapid, but was driven entirely by increased public expenditures. In 1996–1997, the economy adjusted to the second step-down and the lack of further capacity to raise additional finances. Faced with the harsh new realities, the economy crashed and GDP fell by more than 24% in 2 years. In the period that followed, to the end of 2001 (which coincided with the end of the first 15 years of Compact assistance), the economy stagnated and reached a level just 7% higher than in 1987. The PSRP and reforms were clearly unable to stabilize the inevitable economic downturn in the short term. This would have been anticipated. But the PSRP's failure to reinvigorate any subsequent economic growth is disappointing.

58. The impact of economic growth on per-capita GDP was also examined. In the initial period, real incomes rose as economic growth outpaced population growth. Population growth in RMI has historically been high, and grew an average of 4.3% per year during the 1980–1988 intercensal period. But the economy's failure to sustain growth after 1995 had dire

consequences for incomes, and per-capita GDP fell an average of 6.6% annually from 1995 to 2001. This massive reduction had important implications. Many of the population responded by migrating to the US, which grants free residency access to RMI citizens. By the next census in 1999, the rate of population growth had fallen to 1.5% per annum, and over the first 15 years of Compact assistance, real incomes fell by 22%.

59. While the PSRP failed to stabilize the inevitable downturn in the economy or stimulate subsequent economic growth, it was more successful in stabilizing RMI's fiscal position. The PSRP had a significant impact in helping RMI reduce payroll costs and subsidy payments (Appendix 2, Table A2.1). Payroll costs fell each year from FY1995 to FY1999 as the RIF was implemented, and subsidies to public enterprises were cut (Table 1). Impressively, RMI was able to cut expenditures from $57.1 million in FY1995 to $48.4 million in FY1999. Less impressive, revenues also declined during that period, despite initial efforts to increase tax revenue. Although the economy's decline would clearly have had a negative impact on revenue collection, the Government failed to sustain the increase in import duties, and actually reduced rates in 1998 as the 1999 elections approached. Overall, the expenditure reduction was matched by decreased revenue. As a result, the fiscal balance deteriorated from a $2.7 million deficit in FY1995 to $7.2 million in FY2000. The reduction in expenditures was successful, despite failure of the objective implicit in the PSRP: to generate surpluses by the end of the reform.

B. Institutional Impact

60. The PSRP was designed to transform RMI's institutional structure in two important ways: to rationalize government services, and to transform operation of public enterprises. The Program was designed to reduce the number of government departments from 10 to 8 by merging the Ministry of Social Services with the Ministry of Interior, and the ministries of Resources and Development with the Ministry of Works. The PSRP was also intended to rationalize the public service by establishing clearly defined ministerial functions, new job descriptions for public servants, and an efficient system of job grading and incentives. The Ministry of Social Services was merged with Interior as planned, but the merger of Resources and Development with Works was short-lived, with the Ministry of Works reestablished in 2000. There were simply no attempts to rationalize the public service; only in 2003, under the FFMP, was there any attempt to reinvigorate this initiative.

61. Attempts to reform the SOE sector were ineffective. Although the Marshall Islands Shipping Corporation was abolished and its services privatized, the Ministry of Transport and Communications subsequently resumed shipping services in competition with the only remaining operator in the private sector. The financial threat posed by an over-extended national airline was averted early in the PSRP, but AMI still lacks professional financial management, and the airline's existence remains fragile. The PSU was established with TA support, and successfully contracted out KAJUR to private management. But PSU was disbanded when the TA was terminated, even though transformation of the long list of public enterprises had only begun. On the success side, the PSRP saw the institutionalization of MIAA and MIVA, although neither institution has achieved financial nor management independence from the Government.

62. Institutionalization of economic reform is extremely difficult, and requires long-term commitment and sustained effort. The PSRP, with its limited human resources, was ambitious in this regard. Institutionalization of reform requires an understanding that private sector initiative brings about the best results. That appreciation may not be intuitively obvious to remote Pacific Island communities. Institutionalization of reform requires substantial human resources and political commitment. These were identified as potential risks during PSRP design. But political

commitment weakened substantially during the Program, and RMI clearly lacked the capacity to sustain the effort. Abolishing the Department of Public Works and the Shipping Corporation was easy. But the right regulatory environment was not developed and institutionalized. Thus, it is not surprising that the simplest solution, when the private sector did not respond as anticipated, was to bring those activities back under government control. Furthermore, RMI lacked the capacity to maintain the PSU or rationalize the public service. Political will may have faltered, but still, the PSRP was overly ambitious in anticipating that the reforms could have been achieved with the existing institutional capacity.

C. Sustainability

63. The PSRP had two main long-term objectives: (i) to ensure the stability of government finances, and (ii) to improve the environment for private sector development. In the short term, implementation of the RIF and reduction in subsidies to SOEs reduced public expenditures significantly during FY1996 through FY1999 (Appendix 2, Figure A2.2). As discussed in paras. 57–59, on macroeconomic impact, efforts to increase revenues failed, and the deficit worsened. During PSRP's final year, FY2000, fiscal discipline evaporated and most expenditures grew rapidly. A lack of commitment to the RIF achievements caused payroll costs to increase significantly (Appendix 2, Table A2.1). Subsidies to public enterprises and expenditures on goods and services grew rapidly. Overall expenditures grew by a sizable 35% from FY1999 to FY2002. What, under normal circumstances, would have been an unsustainable increase without further deterioration of the fiscal deficit was made possible through four main factors: (i) the tax effort was improved through increased import duties in FY2001; (ii) RMI became the beneficiary of $10 million in grants from Taipei,China, in FY1999; (iii) debt repayment of earlier bond issues secured against future Compact flows was completed by the end of FY2001, releasing additional resources; and (iv) additional funding became available in FY2002 and FY2003 through the Compact's bump-up provisions.

64. The FFMP included provisions to sterilize the additional funding by allocating more bump-up funds, and by committing 60–70% of the noncommitted block grants, to MIITF. This was more than $30 million in funding. But even with this large diversion of funds to MIITF, the bountiful fiscal position enabled a large increase in expenditures and reversal of the discipline achieved during the PSRP. In FY2004, the first year under the new provisions of the amended Compact, RMI is budgeting 43% of Compact funding to infrastructure. The lack of fiscal pressure has enabled RMI to allocate much of its discretionary expenditures to investment. But this fortuitous outcome is fragile. If the large annual grants from Taipei,China, cease, or lack discipline results in uncontained growth in operational expenditures, a fiscal crisis will rapidly develop as the annual real level of future Compact flows declines.[23]

65. The analysis on the institutional impact of the PSRP indicated that most of the attempts to reform the public sector, both government and SOEs, were either not achieved or were not sustained after the closeout of the PSRP. Were it not for the advent of the FFMP through which the Government has committed to maintain the reform initiative, the outcome would be dismal. Through the FFMP, which is more focused and less ambitious in scope, the Government agreed to commit large resources to the MIITF, strengthen fiscal management, and reinitiate efforts to reform the public sector, SOEs, and improve the policy environment for the private sector.

D. Socioeconomic Impact

66. Mitigation of the social impact of downsizing civil service was important to the PSRP (Appendix 3). A compensation package composed of a lump sum and monthly maintenance

[23] Annual grants under the amended Compact are indexed at two-thirds the rate of the US GDP deflator. An annual decrement of $0.5 million is built in.

payments for 3 years was provided to cushion the impact of retrenchment on affected employees. About 463 government employees,[24] including about 190 cooks under the defunct US-supported school lunch program, were entered in the RIF program from 1997 to 2000. Despite financial assistance, households and families of retrenched employees seem to have been adversely affected during the program period. Most retrenched employees seem to have used the lump sum payments to pay off debts, renovate dwellings, buy appliances, and to a lesser extent, for productive investments. At the same time, monthly maintenance payments were relatively small for meeting the needs of large families—characteristic of local households. Given the dearth of alternative employment, the displaced workers adopted several coping mechanisms: (i) emigration to the US, (ii) skilled and nonskilled self-employment, (iii) subsistence farming, and (iv) financial assistance from extended family members.

67. Reduced employment was a major impact of the PSRP. This was as the economically active population increased by 2.3% annually from 1988 to 1999. As a result, unemployment rose significantly, from 12.5% in 1988 to 30.9% in 1999. The number of employed persons in 1999 was almost the same as in 1988. A sharp increase in migration to the US during the program period helped ease pressure on unemployment. But migration seems to have had little impact on the economy, as remittances to RMI were insignificant. [25]

68. The cost reduction measures supported by PSRP were likely a contributing factor in the decline in quality of delivery of social services. It was reported to the OEM that clinics ran out of pharmacy medicines. Sometimes, even basic treatment was not available. From 1997 to 2000, only 81% of the total medical clinics were operational.

69. Assessment of the poverty impact of the PSRP is difficult, given the lack of baseline data. But anecdotal information suggests that some reforms adversely impacted residents of the outer islands, where the highest levels of poverty and hardship in RMI are reported. Privatization resulted in the disruption of domestic shipping services from 1998 to 2000. This affected the population of the outer islands, which depends heavily on reliable shipping services for marketing of copra and handicrafts, its main income sources. The shipping disruption was considered a significant factor in the sudden drop in both copra production and incomes. Furthermore, the PSRP did not include measures to specifically address gender disparity in access to livelihood. Female unemployment rate was higher than male unemployment in both the 1988 and 1999 censuses. But the difference was significant in 1999, when male unemployment was 27.6% versus 37.3% for females (in 1988, male unemployment was 12.2% versus 13.2% for females).

E. Environmental Impact

70. The PSRP had no discernable adverse impact on the environment. Environmental protection agencies remain active as part of government structures.

IV. OVERALL ASSESSMENT

71. **Relevance.** The policy reform program was relevant and consistent with the Government's plan to revive the economy, and with ADB's strategy for the RMI. But even though the depth of analytical study through ADB-assisted TA was timely and comprehensive, it

[24] OEM estimate. No reliable records were available on the actual number of employees who participated in the RIF program. The OEM used a number of sources to collect and verify information, to develop a comprehensive list of retrenched employees.

[25] Most of the surveyed migrant population remitted no funds to RMI. The average remittance for those who did send money back was less than $2,000. In 1999, only 1.4% of the total RMI households derived any of their income from remittances.

may be argued that PSRP did not adequately consider some critical issues restraining growth of the private sector such as inadequate financial services; a deficient legal environment; a costly business environment; and generally weak enforcement of laws and regulations, particularly taxes and duties. The level and breadth of consultation among the Government, the private sector, and affected public groups were also less than desirable. This, combined with the untimely passing of the President in 1996, adversely affected strong country ownership of the PSRP reforms. Overall, the PSRP is assessed as relevant, based on its rationale and the relevance of program design at appraisal and today.

72. **Efficacy.** The PSRP and assistance from other development partners played a role in (i) reducing the probable severity of the 1996–1998 economic downturn, even though real GDP dropped by more than 20%; and (ii) RMI's adjustment to reduced Compact payments over that period. But the PSRP has not significantly contributed to private sector growth. The Government reduced short-term expenditures, but had little success in increasing tax revenue. Long-term structural stability has not been achieved; subsidies remain stubbornly high, there has been little public sector restructuring, and staff levels are again increasing significantly. Reversals in terms of expanded but inefficient government involvement in inter-island shipping through the Ministry of Transport and Communication, resulting in uncertain and infrequent shipping schedules, may partially explain reduced copra production in the outer islands. Licensing and servicing of foreign fishing vessels, and operation of a private sector fish loining plant, have been bright spots for the economy, but attributing these increased activities to PSRP reforms would be difficult. The unquantified but evident growth of small trading enterprises may be partly attributed to the PSRP reforms on business registration. Use of PSRP loan proceeds for compensation helped ease the transition of retrenched government workers, but this was not accompanied by significant efforts to counsel or retrain RIFed workers, or help them find jobs in the private sector. Nor did the Program make any financial services available to finance or help workers start small businesses. Overall, the PSRP is assessed as less efficacious in achieving its primary objectives.

73. **Efficiency.** Of the 59 PSRP reforms and measures, 22 were implemented or substantially completed or completed with delay; 11 were completed but not sustained; and 26 measures were not completed or not substantially completed. Major reforms to downsize government staffing and capital expenditure, merge two ministries, freeze public sector wages, privatize shipping, and reduce subsidies were completed before loan approval. But a number of these early reforms to stabilize government finances in the short term were short-lived.

74. The second tranche was released about 11 months after the original schedule, or 21 months after loan approval, mainly because of difficulties in meeting RIF targets. Of the six release conditions for the second tranche, two were considered relatively unimportant: (i) the reduction in the number of AMI board members, and (ii) the establishment of a small PSU in the Office of the President for no more than 2 years. In addition, the RIF target of 1,482 government staff was moved to the third tranche because the two largest ministries, for education and health, found making further reductions difficult. It may also be argued that the FRTF was not formally established until 2002, and that the nature of the trust was substantively different in purpose than the trust (MIITF) that was established. Similarly, there are indications that subsidies to AMI continued before, and certainly after, the tranche release. Of the five release conditions for the third tranche, the MIAA was not able to provide a self-financing, efficient, and cost-effective airport management service. The Road Users Trust Fund was never operationalized, and the tax on rental income of commercial buildings was not approved (not that implementation would have had substantive impact). On balance, the PSRP is assessed as less efficient in terms of achieving its stated reforms.

75. **Sustainability.** Fewer than half of the PSRP measures were completed, or completed and sustained. Most fiscal and economic indices remain tenuous or have weakened in response to the current Government's major relaxation on hiring, and on budget expenditures without corresponding revenue increases. The economy remains as heavily dependent on external flows as before the Program. The sustainability issue is inexorably linked with the follow-up FFMP loan, financed by ADB, to reinvigorate and expand on the PSRP reforms areas. Sustainability is also linked to the final outcome of the new Compact with the US, which covers the next 25 years (and is likely to offer less assistance and more restrictions on use of funds, as well as increased monitoring of their use). The new Compact trust fund, which will likely amalgamate the MIITF, offers the best chance for long-term economic independence. Thus, while RMI enjoys unique opportunities to achieve long-term and sustainable growth for the private sector, it will require a long-term commitment to significant economic and political reforms. Such commitment has not been demonstrated before. Sustainability is assessed as unlikely.

76. **Institutional Development Impact**. Attempts to institutionalize long-term structural reforms were limited. Efforts to restructure central government services and rationalize the public service were either not undertaken, or the gains achieved were reversed. The only success was the elimination of one ministry. Of the large number of SOEs programmed for transformation, only one enterprise, KAJUR, was placed under private sector management. Two public authorities were created: the airport authority (MIAA) and the visitor's authority (MIVA), but neither has achieved management and financial independence from the Government. The poor outcome resulted partly from a lack of political commitment and from a lack of capacity to affect the reforms proposed. Both risks were identified in the program design.

77. The Program clearly had a negative impact on poverty. The target reduction in public expenditure and RIF resulted in lower employment, reduced household incomes, and substantial migration. But the main question is not what was the negative impact of the Program, but what would have happened had there been no program. After a period of extravagant increases in expenditures, downward adjustment was inevitable. The PSRP lessened the potential hardships by providing RIF payments, although the Program fell short in providing counseling services for displaced public servants. Reform programs often have an adverse political impact; reform-minded governments often lose power as a result of the hardships that the electorate experience. In RMI, the process was the opposite. The previous government lost power due to a lack of good governance, and was replaced with a pro-reform government. Overall institutional development under the PSRP is considered moderate.

78. Based on all the above, the PSRP is rated partly successful.

V. CONCLUSIONS

A. Lessons Learned

79. Perhaps the most significant PSRP weakness was the failure to get widespread community participation or support. The program design and government support were initially during the presidency of Amata Kabua, a powerful advocate of the Program who pushed through the early reforms. After his untimely death, the dearth of alternate champions or widespread realization of the need for reform by the Government, or community at large, became evident. The Program faltered, delaying achievement of RIF targets by 2 years.

80. The PAT team gave professional analytical support to the Program, but failed to gain the Government's confidence, advocate the need for reform, or identify a group of core community supporters. The lack of support had adverse implications, not only for the Program, but also for

ADB. The need for reform was seen as imposed from the outside, in an ad hoc fashion, with ADB responsible for the resulting hardships. ADB clearly has limited capacity to undertake the necessary groundwork in an environment where the community at large is unaware of the need for reform, and must rely on TA support to provide this essential ingredient. The selection of consultants then becomes critical to ensure that not only is professional technical advice delivered, but also that the assistance will gain the support of the community. Although the situation was complicated by the emergence, midway, of a government that did not fully support the reform program, a lack of advocacy also hindered the Program.

81. The PSRP design was overly ambitious and comprehensive, given RMI's limited institutional capacity to support and sustain the reforms. Significant TA was provided to support the Program as part of ADB's country strategy. Many program elements that were not supported by TA, however, were not carried out. Many program elements that were supported, were not sustained after the TA ended. The lesson learned is that in environments with limited institutional capacity to support reform, programs should be well-targeted, with scope restricted to the achievable. There should be commitment to provide long-term assistance if needed.

82. The PSRP was designed on the premise that the private sector would respond favorably to replace the Government as the engine of economic growth, and would provide jobs for the displaced public servants. Although failure of the private sector to respond to the challenge was identified as a program risk, the implicit assumptions about private sector growth were far too optimistic. In an environment where the private sector structure is limited to the production of nontraded goods to support a large public sector, it is unrealistic to envisage that the private sector will develop, in the short term, the capacity to compete in international markets. That is a long-term process. The population's rapid migration in response to falling real incomes was not foreseen. Experience has shown, since the great migrations of the 19^{th} century, that populations will migrate to seek better opportunities in new countries when there are no local opportunities. The RMI is no exception.

83. At the technical level, the PSRP design included a series of both short- and longer-term reforms to improve the fiscal situation, including both revenue and expenditure measures. But the Program did not include monitoring mechanisms to evaluate overall fiscal performance. Such monitoring is normally provided by preparing the fiscal account in a manner consistent with the GFS of the International Monetary Fund (Appendix 2, Table A2.1). Even though the information was available, RMI lacked the internal capacity to generate a GFS account or make projections based on trends and policy interventions. Program lending, which either directly affects or incorporates fiscal adjustment, should provide assistance to develop this capacity, which in any case is essential to sound fiscal management.

B. Key Issues for the Future

84. RMI is starting a new era with the beginning of new economic provisions under the amended Compact. Its fiscal policy has been expansionary in recent years, made possible by a series of beneficial circumstances. But provisions of the amended Compact include annual reductions in grants, due both to a lack of full adjustment for inflation, and the annual decrement. Declining revenues will, thus, soon constrain continued expansion in fiscal policy. The inclusion of a medium-term framework in the annual budgetary process is supported through the FFMP. This will focus attention on the current policy's nonsustainability—a step in the right direction. But the process is long-term; the reductions in Compact funding will be over the next 20 years. Thus, a long-term framework should be developed so that RMI does not again face an unavoidable downward fiscal adjustment during the amended Compact period.

85. Tax reform remains imperative for fiscal policy. The FFMP includes provisions for tax reform, but the effort must be sustained if the PSRP experience is not to be repeated. Strengthening of tax administration is the first step in the process, to rectify the current widespread complaints of smuggling and unfair taxes. After sustained improvements in tax administration, the issues of tax reform and the introduction of VAT should be reviewed again. During the PSRP, the proposed introduction of VAT met widespread opposition from the private sector. But during the OEM, it became clear that the private sector had little understanding of VAT. Many criticisms of the existing regime, such as dislike of the cascading GRT, might be rectified by introducing VAT. But before reopening the debate, the administration of taxes must be considered fair, with the capacity to support a more sophisticated regime.

86. A well-integrated development strategy is needed to address the presently unsatisfactory situation in domestic shipping, outer island airline services, support for copra producers, and poverty reduction in the outer islands. Failure to support outer island communities will accelerate migration, which will threaten the viability of the communities themselves. These interrelated problems have no easy solution. The problems are rooted in a mix of political interests and deeply seated cultural relationships in the Pacific islands.

87. The SOE reform program, initiated during the PSRP, is far from complete. Lack of institutional capacity and political will limit opportunities to advance the process. But this should not deter future efforts that focus on targeted institutions, provided that medium- and longer-term TA support can be sustained, in a favorable political climate.

C. Follow-Up Actions

88. A number of actions are proposed to help implement FFMP and develop sound fiscal policy. These include (i) developing local capacity to prepare a GFS presentation of the budget and fiscal position; (ii) developing a long-term fiscal policy to anticipate real reductions in Compact flows that can be sustained without painful fiscal adjustments; (iii) sustaining efforts started through the FFMP to improve tax administration; and (iv) reviewing the introduction of a VAT in the medium term once tax administration has been strengthened (see Appendix 4 for details).

CONSOLIDATED POLICY MATRIX

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
A. Stabilize Government finances in the short run				
A1: Increase revenues	A1.1 Appoint a tax auditor for 3 months to assess tax revenue arrears.	1 Feb 1996	Completed: MacQuillan Report produced in 1997. Copy is with the Ministry of Finance (MOF). This report names a number of delinquent taxpayers. A tax repayment program and amnesty has been implemented and the Accountability task force is now looking into pursuing these unpaid taxes.	Completed
	A1.2: Introduce a simplified import duty schedule with a basic duty of 12%, a duty of 5% on some basic needs, and a duty of 150% on alcohol and tobacco. The duty on alcohol will be reviewed under the fiscal year (FY) 1997 budget, but will not be less than 100%.	1 Mar 1996	Completed. The Import Duties (Amendment) Act 1996 introduced the new simplified import tax regime. A new import duty act has been passed to overcome the deficiencies in the above bill by lowering many of the excise duties to eliminate the incentive for smuggling and reduce the uniform tax rate to 5% while eliminating many of the special rates. The Government has raised the possibility of eliminating import duties, possibly offsetting the loss in revenue by increasing rates on more easily collected taxes. A decision on this has been deferred until 2001.	Completed for 1 March 1996. But rates have often fluctuated, with basic rates dropping from 12% to 5% in March 1999 (1999–00), and increasing again to 8% in October 2001. Rates on alcohol and tobacco have also fluctuated downward, and effective rates are currently lower than 100%. Local sources indicate that even with lower rates, smuggling remains a serious problem. Total revenues from import duties (excluding duties on fuel) have decreased from $7 million in FY1997 to $4 in FY2001, and $6 in FY2002.
	A1.3: Increase revenue collection efforts to collect $0.5 million in arrears.	30 Sep 1996	Completed.	The Operations Evaluation Mission (OEM) could not document collection of arrears for FY1996 from government sources or program files.
	A1.4: Double the tax on gasoline.	15 Jan 1997	Completed. The Import Duties (Amendment) Act 1996 introduced the increased tax on gasoline. This tax rate has been reduced again from 45% to 20% on gasoline as part of the	Completed. Duties on gasoline fluctuated from $0.25/gallon in 1989 to 45% of cost, insurance, and freight (CIF) in March 1996; to 35% in October 1996; to 20% in March 1999. Duties on diesel were zero in 1989, 30% in March 1996, 20% in October 1996, 5% in

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
			import duty regime.	March 1999, and 8% from 2001 onward. Total fuel duty collections reported for FY1997 were $0.8 million, compared with $0.4 million in FY2000 and $0.3 million in FY2002.
	A1.5 Review all exemptions from paying import duties other than those required by international treaties depending on whether or not a value added tax (VAT) is introduced.	1 Feb 1997	Government's revenue position has suffered as a result of the lowering of imports duties. Consideration is being given to some minor increases to import duties to plug the fiscal created by the fall in imports duties. VAT is no longer under consideration.	Not completed. No action was taken until Section 207 of the Import Duties Act was repealed in February 2002. The Import Duties Act had provided exemptions on a wide range of imported commodities to hotels and tourism establishments, manufacturers, and fishing industries (exemptions were allowed on a case-by-case basis, such as for a new fish processing plant). Local and national governments, state-owned enterprises (SOEs), nongovernment organizations (NGOs), churches, and schools, among others, retain total exemption from duties and gross receipts tax (GRT). Abuse of exemptions remains a significant problem. VAT is not being considered.
	A1.6 Review all exemptions from GRT payments depending on whether a VAT is introduced.	1 Feb 1997	See 5 above.	Not completed (see above). No action was taken on the recommendations for a tax advisor under TA 3668-RMI in June 2002 to change GRT to a sales tax on importers and manufacturers.
	A1.7: Appoint an externally funded tax adviser on customs revenue and taxation to the Government for at least 2 years.	31 Mar 1997	Chief of taxation and revenue and head of customs and statistics recruited by the Australian Government for 2 years. Legislation passed to strengthen administrative powers of the Tax Division, increase penalties for duty evasion. Chief of Taxation and revenue left for medical reasons after 18 months of his 24-month contract. Head of customs has completed his contract. Improvements do not seem to have been sustained.	Completed. But tax administration remains weak, with inadequate staffing, training, equipment, and resources.
A2: Reduce expenditure	A2.1: Instruct all ministries to reduce operating expenses by 3%.	1 Mar 1996	Completed. Appropriation (FY1996) (Amendment) Act 1996 enforced this action.	Completed. Expenditures fell from $58.1 million in FY1995, to $53.8 million in FY1996, to $52.9 million in FY1997. Expenditures in 2002 were $65.5 million (based on estimates of the International Monetary Fund

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
				and the OEM).
	A2.2: Reduce the operating subsidy to the Marshalls Energy Company (MEC) to zero.	1 Mar 1996	Completed. No subsidy provided by the Government in FY1996, 1997, 1998, 1999, and 2000 budgets.	Not fully completed. The Government provided no subsidies from FY1994 to FY1996, but transferred $0.6 million in FY1997. No subsidies were provided from FY1998 to FY2001. The US Compact Energy Grant of $1.9 million was transferred to MEC in FY2002.
	A2.3: Eliminate all vacancies in the civil service and introduce a hiring freeze until 1 October 1996. After that, agreed staff ceilings will apply.	1 Mar 1996	Completed. All vacancies eliminated by 1 October 1996. Vacancies now exist in a number of ministries due to attrition; however, many of these jobs have been eliminated as part of the recent past year budgets.	Completed. However, substantial hiring has occurred subsequent to the end of the Program.
	A2.4: Reduce the operating subsidy to Majuro Water and Sewer Company (MWSC) to zero.	1 Mar 1996	Completed.	Not completed. Operating subsidies were officially zero in FY1996, $0.10 million in FY97 and $0.75 million in FY2002. MWSC has also maintained substantial arrears on withholding taxes, social security taxes, and payments to MEC for electricity.
	A2.5: Reduce operating subsidies to Tobolar to 25% less than the original FY1996 budget appropriation.	1 Mar 1996	Completed. Subsidy to Tobolar was $450,000 in FY1997 representing a decline of 25% on FY1996–FY1998. Budget increased the copra subsidy to $579,000. FY1999 Tobolar subsidy is $481,000. FY2000 subsidy is now back to $800,000 with other debt forgiveness likely. Copra purchasing price is 15 cents per pound, which has put pressure on the subsidy because of recent drops in the world price. Coconut study recommended deregulation of the copra buying industry.	Completed in FY1997. But subsidies to Tobolar were $0.6 million in FY1998 and FY1999, $0.8 million in FY2000, $3.0 million in FY2001, and $1.4 million in FY2002. A reduction of subsidies to the levels proposed through the Program is unrealistic until establishment of alternate transfer mechanisms for people in the outer islands, who depend on copra for their incomes, or until long-term international prices of coconut products increase substantially. Copra buying has not been deregulated.
	A2.6: Reduce operating subsidies to Air Marshall Islands (AMI) by 25% from the original FY1996 budget appropriation.	1 Mar 1996	Completed.	Completed. Operating subsidies decreased from $2.7 million in FY1995, to $1.5 million in FY1996, to $0.3 in FY1997. But by FY2002, subsidies had increased again to $1.5 million.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	A2.7: Retrench about 180 people from the Ministry of Social Services, and include them in the reduction in force (RIF) program.	1 Sep 1996	Completed. This involved the elimination of the school feeding program that was the responsibility of Ministry of Social Services that has now been abolished. Approximately 180 employees were placed on the RIF Program.	Completed. Funding for this school feeding program was originally sourced from a US federal program grant. When the grant terminated, RMI funding continued temporarily. Anecdotal evidence suggests that termination of this highly successful social program adversely affected child nutrition, nationally.
B. Ensure long-term structural stability of Government finances				
B1: Reduce recurrent expenditures by at least 20% during the Program	B1.1: Merge functions of the Ministry of Social Services with those of the Ministry of Interior to form the Ministry of Interior and Social Welfare.	1 Mar 1996	Completed. Youth, women's affairs, community development, and sports and recreation were among the functions transferred to Ministry of the Interior and Social Welfare.	Completed (see A2.7 above).
	B1.2: Impose a 3-year wage freeze for civil servants, excluding normal promotions.	1 Mar 1996	Completed and ongoing.	Completed. The wage freeze is still technically in effect. Real public service salaries have dropped significantly, but remain well above equivalent private sector salaries. Step increases remain in effect.
	B1.3: Merge the ministries of resources and development and of public works.	1 Mar 1996	Completed. Government has now recreated the Ministry of Public Works.	Completed in 1996. The Ministry of Public Works was reestablished in 2000, and now employs 112 staff versus 102 staff in August 1997, before the merger. After the merger, funds allocated for contracting out operation and maintenance (O&M) to the private sector were reportedly used for other purposes, resulting in deterioration of O&M.
	B1.4: Abolish the Marshall Islands Shipping Corporation.	1 Jul 1996	Completed. Marshall Islands Shipping Corporation Act repealed in 1996. The Government has tendered out domestic shipping services. The process is being handled by the Ministry of Transport and Communication (MTC) with assistance	Completed. But the Government is still largely responsible for most inter island shipping through the MTC. Services remain inadequate, shipping losses remain substantial, and contracting to the private sector has not improved service. The sector still depends on subsidies, and has not been profitable for the private sector.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
			from the private sector unit (PSU).	
	B1.5: Reduce the number of government employees to about 1,650 persons, and compensate each retrenched employee with an up-front payment and a monthly maintenance payment over a 3-year period.	1 Oct 1996	Completed. All employees in the RIF compensated according to formula agreed between the Government and the Asian Development Bank (ADB). 2,303 positions in October 1995.	Completed
	B1.6: Second Tranche Condition: Reduce the number of government employees from 1,650 to 1,484 persons. Compensate each retrenched employee with an up-front payment and monthly maintenance over 3 years, as in the formula agreed upon by the Government and ADB, and implemented by the Marshall Islands Social Security Administration (MISSA).	1 Oct 1997	Payroll is at 1,482 as of July 2000.	Completed, but with a delay of almost 3 years. This second tranche condition was deferred to the third tranche, and was expected to be completed by October 1998. Government employees numbered 1,868 in August 2003 (that excludes SOE employees). Payroll costs dropped from $21.4 in FY1996 to $17.0 million in FY1999—but increased to $23.7 million for FY2003 (based on the OEM estimate for FY2003). RIF payments were paid expeditiously, and gave terminated staff a short-term cushion.
	B1.7: Review and reduce, if appropriate, each ministry's operation budget, based on its revised terms of reference, to be developed under C1 in this matrix.	1 Oct 1997	The Government and ADB agreed that it may be premature to introduce this new system. Instead, the remaining funds in ADB's financial management technical assistance (TA) 2767-RMI are being used to strengthen the MOF and reconcile the Government's financial situation with the recruitment of accounting and financial specialists.	Not completed
	B1.8: Second Tranche Condition: End all subsidies to AMI except for the interest payments on the two Dorniers.	1 Oct 1997	FY2000 budget includes no direct subsidy to AMI. Dornier loan now retired.	Completed during the program period, but subsequently reversed. Direct and indirect subsidies continue (see A2.6, above).

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	B1.9: Second Tranche Condition: Continue the 3-year wage freeze for civil servants introduced in March 1996, excluding normal promotions.	1 Mar 1997	Completed and ongoing.	Completed and ongoing (see B1.2, above).
B2: Improve and broaden collection of domestic revenues	B2.1 Undertake a study on the reform of the taxation system, including consideration of VAT, changes in the income tax, import duties and GRT, bearing in mind resource needs, administrative efficiency, and economic resources implications.	1 Sep 1996	Completed. Reports available from the MOF as produced by the Policy Advisory Team. Simplified import duties tax has been passed and the Government is looking at redressing the regressive nature of the wages and salaries tax as well as considering a revamp of the GRT.	Completed. But VAT is no longer being considered. The income tax system as a whole remains highly regressive. The import tax system has not changed substantially, and collections have decreased. The GRT system is essentially unchanged with Government, SOEs, and others still exempt. The efficiency of administration remains weak.
	B2.2: Study the reorganization of the Revenue Division to improve its collection efficiency and productivity, and to prepare it for future changes and improvements in the tax system.	1 Sep 1996	Completed.	Completed. But tax administration officials were unaware of the report or recommendations. Performance indicators of revenue collections indicate few reform measures to improve income tax, GRT, custom collection efficiency, or organizational structure.
	B2.3 Cabinet presentation of the report on taxation reform, and adoption of measured deemed appropriate by the Cabinet.	15 Jan 1997	Completed.	Completed (see B2.2 above).
	B2.4 Reorganize the Revenue Division as recommended by the study and as agreed by the Government and ADB.	1 Mar 1997	Completed. The new structure has been put in place and a request has been made for some additional staff and space to strengthen capacity, with these staff possibly reallocated from lower priority areas within MOF.	Current staffing levels are 11 for the Customs Division and 4 for the Revenue Division. Staff working interchangeably in both divisions is symptomatic of continuing organizational problems and the under-resourcing of this mission critical government function.
	B2.5: Improve customs	1 Mar 1997	Completed. Chief of customs recruited	Completed. But customs operations remain weak, and

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	operations, as recommended by the study and ADB.		with the assistance of the Australian Government. Import Duties (Amendment) Act, passed during the Jan–Mar 1998 session of the Nitijela, strengthening the powers of the Customs Division staff to impound and seize goods, along with other powers needed to improve customs operations.	private sector representatives complain of smuggling and a lack of consistency in customs duties.
	B2.6: Computerize the Revenue, Customs, and Taxation Division.	1 Jul 1997	Completed. The Australian Government has provided $12,000 to upgrade the computers in the division linked to the recruitment of the tax advisers. Desk, computers, and peripherals have been purchased.	Completed. The division continues to use some of the computers purchased in 1997, but has failed to introduce modern tax administration software. PCTrade, a software program for customs administration, was recently introduced, but is far from fully operational.
	B2.7: Third Tranche Condition: Impose a tax on all rental income of commercial buildings.	1 Oct 1997	Was to have been achieved by the introduction of the VAT. VAT is no longer under consideration. The Government considers the tax unnecessary as it raises little revenue and increases the complexity of the taxation system without any efficiency gain. The Government requested a waiver on this condition.	Not completed. No action taken.
	B2.8: Increase the degree of cost recovery and revise road user charges, including vehicle registration fees and fuel taxes, in accordance with the Transport Infrastructure Development TA 2068-RMI.	1 Oct 1997	TA 2756-RMI Institutional Strengthening of the Transport Sector. The TA prepared recommendation for introducing new fuel taxes and registration fees to fund. These are currently under consideration by the MOF.	Not completed. No action taken.
	B2.9: Revise the vehicle classification system. Based on this, impose annual registration fees in accordance with recommendations of the Transport Infrastructure	1 Oct 1997	No action.	Not completed. No action taken.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	Development TA 2068-RMI.			
B3: Establish and/or continue sound management of funds under government control, including RIF funds.	B3.1: Appoint a new board of directors of the Social Security Fund to increase private sector representation.	15 Jan 1996	Completed.	Completed. A new seven-member board (including three members from the private sector) was appointed in 2000.
	B3.2: Retain services of a full-time professional fund manager to ensure the continued integrity of the funds administered by MISSA.	1 Jan 1996	Actuaries have been appointed to administer the MISSA funds.	Not completed. Funds were not managed by a full-time professional until 2000, when the current MISSA administrator was appointed. MISSA funds are now invested in zero-load mutual stocks (60%) and bonds (40%), based on recommendations of a financial advisor (not full time) based in the US.
	B3.3: By a method to be agreed upon by the Government and ADB, appoint representative beneficiaries and potential beneficiaries of the funds administered by MISSA, on the MISSA board.	1 Feb 1997	Completed.	Completed.
	B3.4: Second Tranche Condition: Establish a Financial Reserves Trust Fund that will enable the creation of financial reserves for periods of severe financial difficulties, with details to be agreed upon by the Government and ADB.	1 Oct 1997	Completed. Legislation establishing the Marshall Islands Intergenerational Trust Fund (MIITF) passed. The legislation includes a draft international agreement to solicit third party contributions to the MIITF from willing donors. Initial government contribution of $500,000 set aside from the second tranche of the public sector reform program (PSRP) loan. Third tranche meaning total Fund is around $2.2 million.	Not completed as originally intended. No fund to enable the creation of financial reserves for periods of severe financial difficulties was established. The MIITF legislation was enacted in March 1999, but was designed to provide a secure income source for long-term revenue needs after the 2024 end of the amended Compact with the US. MIITF was formally established in 2002. Funds will be amalgamated with amended Compact trust funds. Tying up ADB loan funds in this trust defeats the intended PSRP objective of short- and medium-term fiscal stabilization. MIITF does, however, provide a vehicle for investment of budget savings.
	B3.5: Third Tranche Condition: Establish the Road Users Trust Fund to ensure adequate funding for routine and periodic road	1 Oct 1997	Completed. Legislation has passed the Nitijela establishing the fund.	Completed, after delays, in March 1999. But no legislation has been implemented, nor have funds been allocated to this trust fund.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	maintenance and road traffic safety. Assign an adequate portion of the proceeds of road user charges to the fund, and the balance to the general budget.			
	B3.6: Have an independent auditor audit the Road Users Trust Fund annually. Implement the auditor's recommendations to ensure long-term viability of the fund.	1 Oct 1998	Completed. Legislation includes a requirement for independent audit.	Not completed. The trust fund was never operationalized.
C. Improve the environment for the private sector				
C1: Reduce Government's involvement in the economy	C1.1: Appoint a professional and experienced interim manager for AMI. Provide management with the necessary support to reorganize and streamline AMI to make it financially sound. Retrench 50 of the staff of 120.	1 Feb 1996	Completed. Professional manager appointed in 2000. AMI staff now around 130 employees, down from over 200. AMI is considering contracting out a number of its services, including its outer-islands agents, to bring the numbers down to this figure completed.	Partially completed. After a period of high turnover of professional managers, AMI has had an experienced professional manager (for operations, but not finance) for the past 3 years. Current staffing is 78, excluding 26 part-time outer island agents. Financial strength remains weak, and working and fixed capital needs remain dependent on government funding and/or Marshall Islands Development Bank (MIDB) loans. A major debt to equity swap and share offering for about $9.0 million was completed with four government entities in 1996.
	C1.2: Pursue and implement a least-cost option to end the lease contract for the DC-8.	1 Sep 1996	Completed.	Completed. Operations have been streamlined with the sale of the DC-8 in 1996, an HS 748 in 1998, and the SAAB 2000 in 1998.
	C1.3: Appoint a permanent chief executive officer who is an internationally qualified and experienced airline manager, with a remuneration package in	1 Feb 1997	Completed. The new spell has been guaranteed full autonomy in personnel, scheduling, fare setting, etc.	Not completed. There has never been a permanent chief executive officer (CEO). The current general manager performs most CEO functions. His remuneration package is not highly attractive, by international standards.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	accordance with international standards. Fully implement the other recommendations made in Appendix 1 of the *Air Marshall Islands Review* report.			
	C1.4: Provide AMI management with clear delegated powers and adequate resources, including an operational budget, to manage the airline on a strictly professional basis, including the setting of tariffs and flight schedules, and handling personnel matters.	1 Feb 1997	Completed.	Not completed. Management has neither adequate resources nor clearly delegated powers. Airfares have not changed in, at least, the past 3 years. AMI does not have full discretion on personnel matters or flight schedules. As a result, opportunities for potential profitable service additions have not been realized (i.e., expanded services for US military stationed in Kwajalein).
	C1.5: Second Tranche Condition: Reduce the board of directors of AMI from nine to five members. Ensure that at least two members are from the private sector, with relevant commercial experience.	1 Feb 1997	Completed. By a Cabinet decision in January 1997. However, with the concurrence of ADB, the board has been expanded to seven members, including three private sector representatives with the relevant commercial experience.	Completed. For the past 3 years, the board has comprised six members; three are from the private sector. The chairperson is the Minister of Transport and Communication. The board appears to be genuinely interested, and involved, in making AMI financially sound.
	C1.6: Second Tranche Condition: Establish a PSU in the Office of the President for a period of no longer than 2 years. The PSU will consist of three qualified part-time staff members, appointed by the President.	1 Feb 1997	Completed. Cabinet has established a PSU in the Office of the President. The PSU coordinator is working with the international consultants. International consultants have conducted detailed investigations of private sector.	Completed, but with delay. TA 2757RMI: Support of the Private Sector Unit went into effect in November 1998. Only one part-time counterpart staff was assigned to the PSU.
	C1.7 Prepare a detailed action plan for the implementation of the Government/United Nations Development Programme	1 Feb 1997	Completed. Assistance focused on Ministry of Education, the largest ministry.	Not substantially completed. Under execution in 2003 is the Small Scale Technical Assistance for a Public Service Review, ADB TA 3668-RMI, which addresses many of these issues.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	(UNDP) Public Sector Management Improvement Program (PSMIP) report as outlined in the December 1995 report of the Rationalization Committee. The plan will include new terms references for all ministries, staffing requirements, and improved personnel management methods.			
	C1.8: The PSU will complete its review of PSEs, including AMI, domestic shipping, MWSC, MEC, and National Telecommunications Authority. The PSU will develop a preliminary framework for private sector regulation. Conclusions and recommendations of the PSU will be submitted to the Cabinet for review and implementation in a manner agreed upon by RMI and ADB.	1 Jul 1997	Completed.	Partially completed, with delay. Reviews were completed in March 1999. None of the nine SOEs recommended for privatization were undertaken. But KAJUR was contracted out for private sector management in 2000. KAJUR is now intended to be reestablished as a government corporation. The management of Tobolar (copra transport and processing) has also been contracted to the private sector. The Outrigger Hotel, National Telecommunications Authority, and Marshall Islands Drydock, Inc., are also under private sector management. Subsidies and losses in the SOEs continue to be a major burden on public sector finances. The recommended framework for private sector regulation has not been adopted.
	C1.9: PSU will complete its review of Tobolar, taking into account the Government's social policy associated with copra production, and recognizing the importance of copra for cash income on the outer islands.	1 Jul 1997	Completed.	Technically completed. But recommendations of the review have not been substantially adopted. Copra production has declined, procurement and processing remain inefficient, and subsidies remain high.
	C1.10: Conduct a comparative study of private and public sector salaries to provide an improved basis for	1 Jul 1997	No action.	Not completed.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	setting public sector salaries, and establish a methodology for regular monitoring.			
	C1.11: Third Tranche Condition: Establish the Marshall Islands Airport Authority (MIAA) by legislative enactment, to provide more efficient and cost-effective airport management, that is self-financing.	1 Oct 1997	Completed. Enabling legislation passed by the Nitijela. Director appointed by the MIAA Board after advertising. Board is considering the revision of airport charges recommended under ADB's TA 2757-RMI: Support of the Private Sector Unit.	Completed. The legislation was approved in 2000. MIAA became operational in 2001. Commercial operations have not been achieved (i.e., the Government continues to pay a lease of about $400,000/year to use the Majuro airport).
	C1.12: Third Tranche Condition: Transfer all current airport management functions to the new MIAA.	1 Oct 1997	Completed. MIAA legislation transfers all management and operational functions of the Directorate of Civil Aviation (DCA) to MIAA. A small regulatory body, the DCA will remain under the Ministry of Transport and Communication to regulate the operations of the MIAA.	Completed.
	C1.13: Implement the action plan for the PSMIP, including the reorganization of the ministries, new job descriptions for civil servants, a new job grading system, and provision of adequate incentives.	1 Jan 1998	PSC recruited a consultant under UNDP funding to help review the public service regulations in March 1998.	Not substantially completed. PSMIP had recommended reducing the number of ministries from 10 to 6. The Government eliminated the ministries of Public Works and Social Services—but then reinstated the Ministry of Public Works in 1999. Other civil service issues addressed by the Small Scale Technical Assistance for a Public Service Review (ADB TA 3668-RMI), are being implemented in 2003.
	C1.14: Reestablish the Marshall Islands Visitor's Authority (MIVA) with a board of directors that has majority representation from the private sector. Produce a business plan to reduce government support to zero within 3 years. MIVA will become a focal point for tourism development in the	1 Feb 1997	Completed. MIVA is now an autonomous Government authority established as of 1 October 1997 and employing three staff. In line with international practice, MIVA does not envisage phasing out Government funding altogether. The business plan envisages funding from a combination of sources, direct budget support, departure taxes, room taxes, and	Partially completed. MIVA autonomy is limited because most funding is directly supported from government budgets. Intentions to fund part of departure and room taxes were never realized. The board of directors is now composed of seven members; five are from the private sector.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	RMI.		promotion levy.	
	C1.15: Review the privatization procedures that were followed regarding domestic shipping, and implement the recommendation as agreed by the Government and ADB.	1 Feb 1997	Completed. Government reviewing the system to strengthen enforcement.	Not completed. In the past 3 years, MTC has invested heavily in shipping (more than $4 million), and now operates four major inter-island vessels (including one tanker). The private sector owns and operates one large cargo ship.
C2: Improve the regulatory environment .	C2.1: Third Tranche Condition: Registration of companies to be the sole responsibility of the registrar of corporations, to ensure fair and transparent treatment for all companies.	1 Apr 1998	Completed. Associations Law (Amendment Act) passed Nitijela in March 2000.	Completed.
	C2.2: Review of the policy and procedures for employment of noncitizens to ensure more transparency is the issuance of work permits, in a manner agreed upon by the Government and ADB.	1 Apr 1997	Legislation has been prepared and introduced to the Nitijela. The legislation has now lapsed but the Government indicates it will be reintroduced.	Not completed. Procedures for employing noncitizens remain burdensome, and inhibit the efficiency of the private sector.
	C2.3: The procedure for issuing of business foreign investment licenses will be made more transparent and automatic in a manner agreed upon by the Government and ADB.	1 Apr 1998	Legislation passed March 2000.	Completed in March 2000. But other issues regarding security of land leasing, work permits, financial services, other administrative restrictions, and inconsistent fiscal policy (constantly changing tariff rates) have discouraged significant foreign investment.
	C2.4: The Government will guarantee foreign investment protection by applying for membership in the Multilateral Investment Guarantee Agency and International Center for	1 Apr 1998	Alternative dispute resolution legislation prepared Arbitration Act and introduced into the Nitijela. Legislation has now lapsed.	Not completed.

Objectives	Specific Policy Actions	Target Date for Completion	Status at Program Completion Report December 2000	Program Performance Audit Report
	Settlement of Investment Disputes. National legislation will be enacted to allow for comprehensive foreign investment protection.			
	C2.5: Enact legislation for the establishment of an ombudsman to investigate complaints, to ensure independent arbitration between the Government and the public. The procedures and powers will be agreed upon by the Government and ADB.	1 May 1998	No action so far.	Not completed.
	C2.6: Enact legislation and procedures to guarantee legal security of land leases, as well as peaceful enjoyment of the right of occupancy under the leases, while ensuring that all concerned customary owners receive a fair return on land leased that is commensurate with market conditions.	1 May 1998	Legislation will be re-introduced into the Nitijela and will be discussed at the National Economic and Social Summit November 2000.	Not substantially completed. The Nitjela approved the Marshall Islands Development Land Registration and Authority Act in 2001. But deficiencies of the law include the lack of adequate guarantee provisions. The ongoing TA 3941-RMI—Mobilizing Land in the RMI—has helped the Government prepare a new, voluntary draft for land registration legislation, and operation of a land registration authority.

GOVERNMENT STATISTICS

Table A2.1: Central Government Finances
($ million)

(Fiscal Year)

Item	1995	1996	1997	1998	1999	2000	2001	2002
Total Revenue and Grants	77.7	78.1	68.8	71.5	65.5	74.1	81.7	79.7
Total Domestic Revenue	34.9	36.0	27.8	24.7	23.7	24.4	23.6	27.5
Taxes	19.5	19.4	18.6	18.7	16.9	17.0	18.4	20.1
Income	9.3	8.5	8.1	7.6	7.6	8.7	9.6	9.6
Gross Revenue	3.1	3.9	2.7	2.7	2.5	3.2	3.8	3.5
Imports	6.3	5.7	7.0	7.5	6.2	4.2	4.0	6.0
Other	0.9	1.3	0.8	0.8	0.5	0.9	0.9	1.0
Nontax	15.4	16.6	9.2	6.0	6.8	7.3	5.3	7.4
Fishing Rights	2.2	1.6	1.9	1.3	2.3	3.7	1.8	3.3
Fees and Charges	2.0	2.8	1.9	0.6	0.6	0.9	1.0	1.6
Investment Income	6.2	1.1	0.8	1.6	0.6	0.5	0.4	0.4
Other	5.1	11.2	4.6	2.4	3.3	2.3	2.0	2.1
Grants	42.8	42.1	41.0	46.8	41.8	49.7	58.1	52.2
Current	19.4	14.1	18.0	22.9	18.8	26.7	34.8	32.9
Compact	36.4	34.6	30.4	30.9	30.9	31.1	31.4	32.7
Other	6.4	7.5	10.6	15.9	10.9	18.6	26.7	19.5
Total Expenditures	100.1	60.1	60.4	56.6	55.3	65.1	72.1	72.9
Current Expenditures	57.1	53.8	52.9	51.8	48.4	58.2	65.9	65.5
Wages and Salaries	21.9	21.4	18.8	18.0	17.0	17.4	18.8	21.5
Goods and Services	18.0	17.5	17.8	21.6	18.8	25.5	30.2	30.8
Interest Payments	7.5	7.5	6.8	5.4	4.3	2.0	1.5	0.6
Subsidies and Transfers	9.7	7.3	7.5	6.2	7.5	13.1	15.4	12.7
Reduction in force Payments	0.0	0.0	2.1	0.6	0.8	0.3	0.0	0.0
Capital Expenditure	43.0	6.4	7.5	4.8	6.9	6.8	6.2	7.4
Current Balance	(2.7)	(3.7)	(7.1)	(4.2)	(5.9)	(7.2)	(7.6)	(5.2)
Overall Balance	(22.4)	17.9	8.4	14.9	10.2	9.0	9.6	6.8
Use of Surplus		17.9	8.4	14.9	10.2	9.0	9.6	6.8
Net Government Debt Repayment	(12.2)	12.4	7.3	11.0	27.0	5.6	14.8	(8.6)
Principal Repayment	16.2	16.5	17.9	19.0	42.3	16.7	24.0	1.1
Gross Borrowing	(4.1)	(4.1)	(10.7)	(7.9)	(15.3)	(11.1)	(9.2)	(9.6)
Change in Government Financial Assets	34.6	5.6	1.1	3.8	(16.8)	3.4	(5.2)	15.3
Trust Fund								17.5

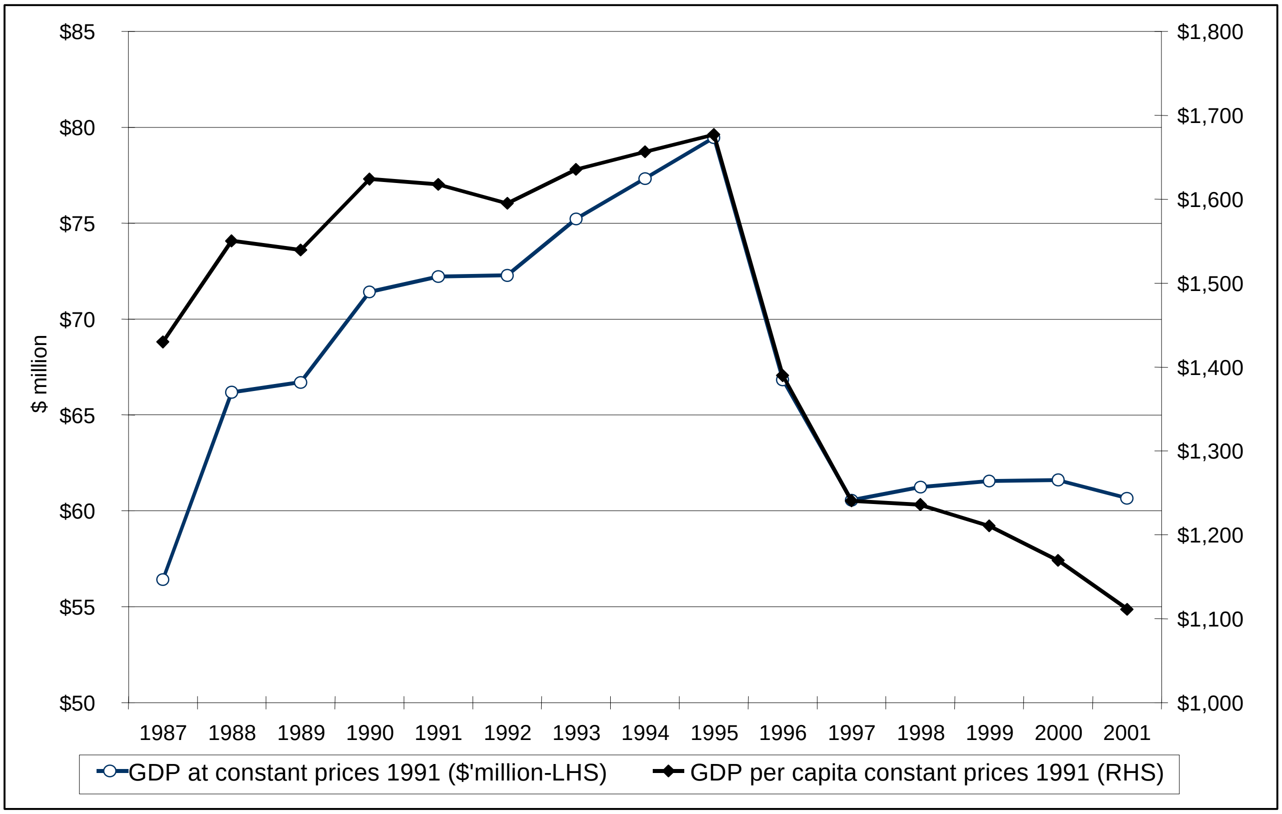
Source: International Monetary Fund and Operations Evaluation Mission update for FY2001 and FY2002.

Table A2.2: Public Service Employment at the Program Completion Report and Operations Evaluation Mission
(No. of Employees)

Ministry or Unit	October 1995	PCR June 2000	OEM September 2003
Attorney General Office	10	11	26
Auditor General	7	7	11
Cabinet	13	8	20
Chief Secretary	24	22	12
Council of Iroj	4	3	13
Education	733	667	700
Finance	72	53	99
Foreign Affairs	39	28	31
Health and Environment	422	352	446
Internal Affairs and Social Welfare	74	49	50
Judiciary	20	15	19
Justice	167	165	161
Others	18	2	1
Marine Resources Authority	36	0	0
Nitijela (Parliament)	21	10	37
Public Service Commission	10	4	11
Public Works	180[a]	0	112
Resources and Development	[a]	68	34
Special Appropriation	0	0	2
Transport and Communication	94	20	83
Total	**1,944**	**1,484**	**1,868**

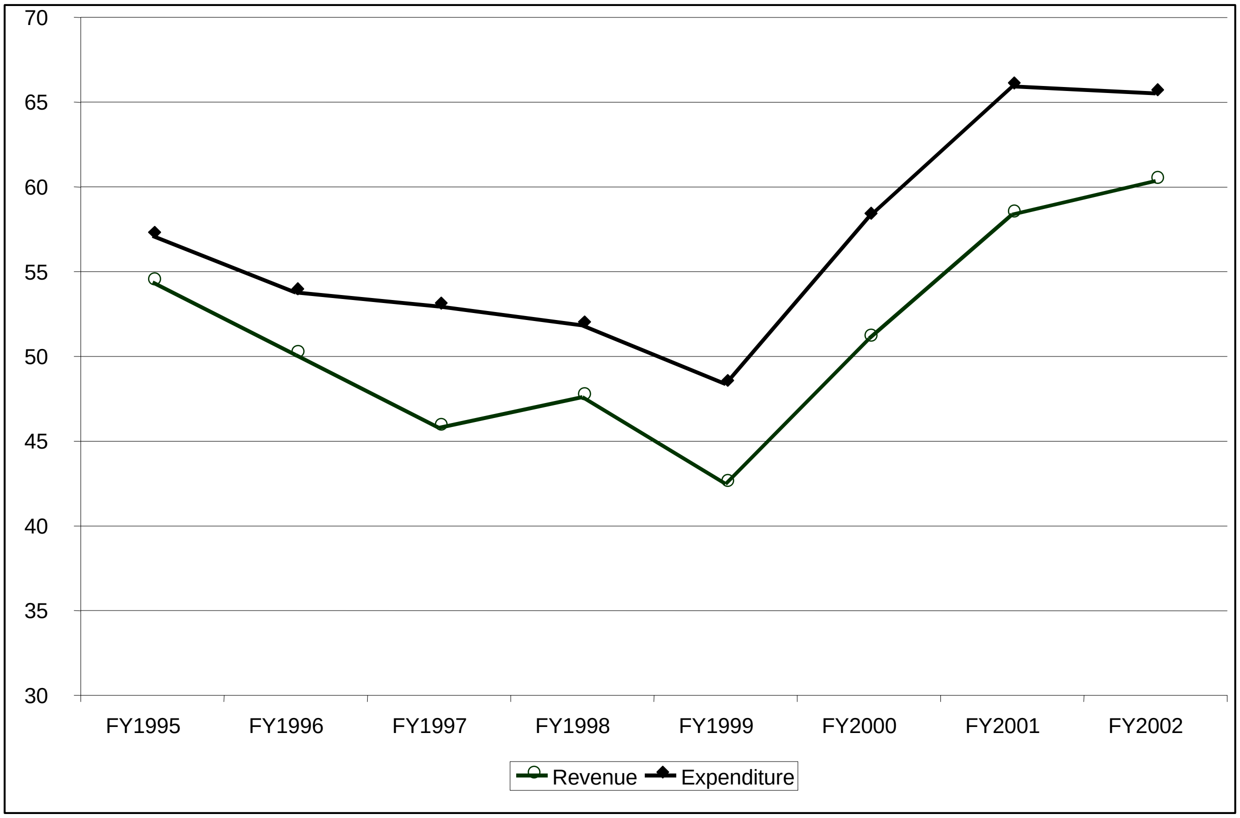
OEM = Operations Evaluation Mission, PCR = program completion report.
[a] Public Works and Resources and Development combined.
Source: For 1995, Ministry of Finance payroll.

Figure A2.1: Real Gross Domestic Product and Per-Capita Gross Domestic Product
(1991 prices)



GDP = gross domestic product, LHS = left-hand side, RHS = right-hand side.
Sources: Asian Development Bank, International Monetary Fund, Ministry of Finance, and Operations Evaluation Mission estimates.

Figure A2.2: Government Current Revenues and Expenditures
($ million)



FY = fiscal year.
Sources: Asian Development Bank, International Monetary Fund, Ministry of Finance, and Operations Evaluation Mission estimates.

SOCIOECONOMIC IMPACT ASSESSMENT

A. Introduction

1. The Republic of the Marshall Islands (RMI) comprises a large expanse of ocean and hundreds of low-lying resource-poor coral atolls of which about 25 are inhabited. Over the past century, 70% of the population has come to be concentrated in the urban areas of Ebeye and Majuro. Accordingly, subsistence dependency is low, as is domestic food production and the productivity of small-scale commercial agriculture and fisheries, which is confined mainly to a minority of producers living in outer islands. Most people depend on cash for their food and other basic necessities. The country has a history of very limited private sector development and high levels of dependence on public sector wage employment and subsidized food programs, as well as income from land rentals and other nonprivate sector sources, including compensation payments for damages sustained by some island populations during nuclear weapon testing experiments in the 1950s. Accordingly, the RMI has special social and hardship issues and problems, and the country faced particular vulnerability in the face of necessary reductions in public sector employment and public expenditure advocated by public sector reform program (PSRP).

2. The social and economic impacts of the PSRP were originally to be monitored by the former Office of Planning and Statistics,[1] but that did not happen. For this assessment, the Operations Evaluation Mission (OEM) relied on field interviews, census data, and other secondary data. The overall socioeconomic impact of PSRP was analyzed by comparing selected indicators for the pre-, during-, and post-program periods. A comparison of these indicators showed that contraction of the public sector contributed to changes in the characteristics of the demography and economic activity of RMI, as well as to the quality of its social and transport services.

B. Impacts on Retrenched Employees

3. Mitigation of the social impact of downsizing of the civil service was an important aspect of PSRP. A compensation package composed of a lump sum and monthly maintenance payments for 3 years was provided to the retrenched employees to cushion the impact of retrenchment. But the retrenched employees did not receive training or counseling on how to cope with the loss of employment, and how to use their severance payments. Given the extent of cash dependency in RMI and the weakness of the private sector, this appears to have been a significant omission.

4. About 463 government employees[2] (including about 190 cooks under the lunch feeding program) were entered in the reduction in force (RIF) program from 1997 to 2000. Despite the financial assistance, anecdotal information suggests that during the program period, households and families of retrenched employees were adversely affected. Most retrenched employees seem to have used the lump sum payments to pay off debts, renovate dwellings, buy appliances, and, to a lesser extent, to make productive investments. At the same time, monthly maintenance payments were relatively small to meet the needs of the large families that are characteristic in RMI. Given the lack of alternate employment opportunities during the program

[1] Dissolved in 2002. The Economic Policy, Planning, and Statistics Office, established in early 2003, assumed responsibilities for collection, analysis, and dissemination of statistics.

[2] This is an OEM estimate. There were no reliable records of the actual numbers of employees who participated in the reduction in force (RIF) program. The OEM must collect and verify information from various sources to develop a comprehensive list of retrenched employees.

period, the displaced workers adopted several coping mechanisms: (i) emigration to the United States (US) (mainly to Arkansas and Hawaii); (ii) self-employment (e.g., taxi drivers and electricians for urban residents, and copra farming and handicraft making for outer island dwellers); (iii) subsistence farming such as fishing, raising pigs, and a limited range of atoll crops such as coconuts, breadfruit, taro, and pandanus fruit; (iv) financial assistance from extended family members; and (v) employment in the private sector.

5. Data analysis plus field interviews indicate that 70% of the retrenched employees remain in RMI, while about 10% are now in the US. Another 7% have died. No information is available on the other 13%. Of the affected employees who are now in RMI, about 49% (157) reside in Majuro Atoll, 46% (161) in the outer islands, and 6% in Kwajelein and Ebeye. About 52 (32%) of those residing in Majuro are currently employed (of which 39 were rehired by the Government and some receive higher salaries than before), and 33 (21%) do not work. But anecdotal evidence suggests that some of the retrenched employees who live in the outer islands are engaged in copra farming and handicrafts.

C. Impacts on Employment

6. A major PSRP impact was a reduction in employment opportunities even as the economically active population increased at a rate of 2.3% annually from 1988 to 1999. As a result, unemployment rose significantly—from 12.5% in 1988 to 30.9% in 1999. The number of employed persons in 1999 was almost the same as in 1988.

7. The decreased government spending led to a decline in the share of public sector employment. Contrary to the expectation that the private sector would make up for the loss, the decline in public sector employment was accompanied by decreased private sector employment—which suggests that the private sector existed largely as a secondary sector, dependent on the public sector. The shares of employment in the public sector dropped by 8%, and shares in the private sector by 10%, from 1988 levels. But that drop was compensated by the increased number of self-employed (mostly engaged in subsistence activities), and small family businesses (from 2,073 in 1988 to 2,920 in 1999, a 40% increase) (Table A3.1).

8. The distribution of employees by industry also changed from 1988 to 1999. The share of community, social, and personal services increased from 30% in 1988 to 38% in 1999. The increase made up for the drop in shares of other industries such as wholesale and retail trade, construction, and manufacturing. The share of agriculture and fisheries remained stable, at 21%. By occupation, the share of production workers, laborers, and transport equipment operators, which comprised the largest occupational group, dropped from 30% in 1988 to 24% in 1999. Meanwhile, the shares of clerical, service, and related workers increased by about 3–4% from 1988 levels (Table A3.1).

9. Paid employees were highly concentrated in the urban areas while the self-employed or people engaged in subsistence activity are in the rural areas. According to the 1994 Household Survey and the 1999 Census of Population and Housing (CPH), paid employees comprised about 90% of the urban employed population compared with about 30% in the rural areas. About 70% of employed population in the rural areas was self-employed or own account workers, majority of which are copra farmers and handicraft makers. The imbalance had resulted in a high level of income inequality between urban and rural areas. In 1999, about 64% of households living in rural areas reported receiving annual income below $3,000 compared with only 8% of households in the urban areas. The median income for RMI was estimated at $6,840 (Table A3.2). While this indicates a median daily income of around $18 per day, well

above accepted definitions of income poverty, the high dependency ratio and high prices of mainly imported food, goods, and fuel must be factored in.

D. Impacts on Migration

10. The PSRP was also likely to have been a contributing factor to the sharp increase in migration to the US (but less in the US Trust Territories). According to the surveys conducted on the communities in Arkansas, Hawaii, Guam, and Commonwealth of Northern Marianas Islands (CNMI), the number of emigrants to Hawaii and Arkansas has increased significantly since 1995 (Table A3.3). On the other hand, unlike other Micronesians, very few Marshallese emigrated to Guam and CNMI. The main reasons (accounting for 61%) cited for migrating were employment, and as spouse and as dependent of employed person. Most of the emigrants were high school graduates and from the younger age group. About 34% of the migrant population surveyed was less than 15 years old and about 43%, between 15 and 29 years old. However, despite the increased outward migration of this age group, unemployment rate remained high in RMI for ages between 15 and 29 years old. According to 1999 CPH, unemployment rate for this age bracket was about 52%, much higher than the national unemployment rate of 31%.

11. The massive emigration in the mid-1990s caused a slowdown in the average annual growth rate of the population, from a high of 4.3% in 1988 to a low of 1.5% in 1999. RMI's total population in 1999, according to the CPH was 50,840, up from 43,360 in 1988—an increase of 7,460 people over 11 years. The fertility rate declined from 7.2 children per woman in 1988 to 5.7 in 1999. Likewise, the crude birth rate dropped from 49 per 1,000 in 1988 to 42 per 1,000 in 1999, while the crude death rate decreased from 9 per 1,000 in 1988 to 5 per 1,000. A combination of a relatively high fertility rate and a declining mortality rate resulted in a country with 43% of its population less than 15 years old.

12. Emigration may be viewed positively in terms of demographic issues. Of all Pacific Island developing member countries (PIDMCs), RMI has the region's most concentrated urban populations, its highest crude fertility rate at 5.7 and the most limited terrestrial resources per capita. Even with people emigrating to the US and elsewhere at the rate about 20 per thousand, the program population growth rate for 2000–2025 is still high at 2.0% and the population will double in 35 years.[3] The massive emigration of younger Marshallese has lessened competition for the limited employment opportunities and resources available to them.

13. However, outmigration does not appear to have had much impact on the economy. Unlike many other migration-prone PIDMCs, remittances to RMI were insignificant. Surveys conducted by the US Census Bureau, or under its auspices, show that members of Marshallese migrant communities in the US and its territories seldom remit funds to RMI, and for the few that do, the average annual remittance was less than $2,000. In 1999, only 1.4% of the total RMI households derived their income from remittances (Table A3.2) in comparison to the neighboring Federated States of Micronesia (FSM) where 40% of household received remittance income from within FSM or abroad.

14. This may be explained by the fact that labor migration began comparatively recently in RMI. Compared to other Micronesians, in the past Marshallese traveled less,[4] and those who

[3] South Pacific Community 2000–2025 Population Projections, August 2001.

[4] Nero, Karen L., and Faustina K. Rehuher. 1993. Pursuing the Dream. Historical Perspectives on Micronesian Movement Patterns in *A World Perspective on Pacific Islander Migration: Australia, New Zealand and the USA*. Centre for Pacific Studies, University of New South Wales.

did mainly left the country to study, or because they married people from the US. Accordingly, Micronesian communities in the US tend to be small and dispersed unlike many other Pacific migrant communities. A study of the relatively large Marshallese community in Orange County near Los Angeles in the early 1990s showed that not only did Marshallese migrants rarely send money home, but that a significant proportion actually received money remitted by from relatives from RMI to the US.[5] The numbers of people in RMI who at the time received rents and various compensation payments may at least partially explain this. It is likely that in future, more Marshallese in the US will remit money to kin in the RMI.

E. Impacts on Social Services

15. The cost reductions supported by PSRP probably contributed to the decline in quality of social services. It was reported to the OEM that clinics ran out of pharmacy medicines and sometimes, even basic treatment was not available. From 1997 to 2000, only 81% of RMI's medical clinics were operational.

16. The delivery of education services has not improved markedly. The quality of education remains poor. At the elementary level, private schools outperformed public schools, based on two yearly performance tests[6] given to eighth graders. The percentage of private school students passing the entrance test for the period 1993–1999 was 51% versus 31% for public school students. Similarly, test results for the Pacific Islands Literacy Level Skills from 1994 to 1998 showed a higher percentage of private school students (59%) achieving the minimum standards in English, math, and Marshallese than for public school students (29%). For secondary level students, performance was based on results of a placement test given by the College of Marshall Islands. No comparative data are available for private and public schools, but the average passing rate for the last 5 years has been 59%.

F. Impacts on Poverty

17. It is difficult to determine the specific impacts of the PSRP on poverty given the lack of baseline data. It is even more difficult to predict the counterfactual impact on poverty had no PSRP been forthcoming and the government's fiscal crisis had been allowed to further grow. However, reports on human development in the Pacific suggest that RMI's standard of living deteriorated during the program period. Based on the estimate of the human development index[7] (HDI), the 1999 Pacific Human Development Report ranked RMI (with an estimated HDI of 0.563) 8th among the 12 PIDMCs. This is a decline; RMI ranked fifth (with an estimated HDI of 0.611) in 1994.

18. RMI is highly urbanized; about 70% of its population lives in urban areas of Majuro Atoll and Ebeye. Most urban households depend largely on wages and salaries. High unemployment—more than 30%— and limited subsistence opportunities have led to rising urban poverty. This, in turn, has produced associated problems of inadequate and overcrowded housing, poor water supply and inadequate sanitation, poor diets, and malnutrition.[8] The

[5] Hess, Jim, Karen L. Nero, and Michael L. Burton. 2001. Creating Options: Forming a Marshallese Community in Orange County, California. *The Contemporary Pacific*. University of Hawaii Press.

[6] High school entrance test and the Pacific Islands Literacy Level Skills (PILLS) test, given yearly to determine the number of at-risk students in three subject areas—English, Marshallese, and mathematics.

[7] HDI measures achievements in three dimensions of human development: longevity, knowledge, and a decent standard of living.

[8] Malnutrition includes both under-nutrition in infants and children and obesity in older age groups, the latter often resulting from very poor quality diets and leading to a high prevalence of type II diabetes.

younger population, 5 to 19 years old, is particularly vulnerable to poverty. In 1999, this age bracket had about 73% unemployment. The inability of this young group to absorb into wage employment may contribute to RMI's increasing youth-related problems, such as alcohol abuse.

19. Anecdotal information also suggests that some reforms have adversely affected residents of the outer islands, most of whom were already highly impoverished. The privatization of domestic shipping services (supported by PSRP) disrupted shipping services from 1998 to 2000. This affected most outer island families, who depend heavily on reliable shipping services for copra and handicrafts, their main income sources. Nonreliability of shipping caused a sudden drop in both production and incomes, because copra could not be shipped from the outer islands. Copra production dropped from a peak of 7,200 tons in 1995 to a low of 3,350 tons in 1999. The drop in world copra prices, and the reduced government copra subsidies, also contributed to lower incomes.

20. Consumption patterns also seem to have shifted during the Program. Agricultural production for home consumption, and livestock production, have increased significantly (Table A3.4), lessening reliance on imported food products. The value of food and live animal imports dropped from $18 million in 1995 to about $5 million in 1999. Consistent and pervasive reports of significant increases in smuggling during the period may account for a portion of the recorded decrease in food imports.

21. The PSRP provided no measures to address the continuing gender disparity in access to livelihood. The unemployment rate for females was higher than for males in both the 1988 and 1999 censuses. But the difference was significant in 1999, when the male unemployment rate was 27.6% versus 37.3% for females. The 1988 unemployment rates were 12.2% for males, and 13.2% for females.

Table A3.1: Selected Social and Economic Indicators, 1988 and 1999

Item	1988 Male	1988 Female	1988 Total	1988 % of Total	1999 Male	1999 Female	1999 Total	1999 % of Total
Working Age Population (15 years and over)	10,819	10,425	21,244		14,595	14,103	28,698	
Percentage of Total Population	48.8	49.2	49.0		56.1	56.8	56.4	
Economically Active Population	8,353	3,135	11,488		9,679	4,998	14,677	
Percentage of Working Population	77.2	30.1	54.1		66.3	35.4	51.1	
Employed Population	7,335	2,721	10,056		7,008	3,133	10,141	
Percentage of Economically Active Population	87.8	86.8	87.5		72.4	62.7	69.1	
Unemployed Population	1,018	414	1,432		2,671	1,865	4,536	
Unemployment Rate (%)	12.2	13.2	12.5		27.6	37.3	30.9	
Employed Population				% of Total				% of Total
Class of Workers								
Employee (Public Sector)			3,392	33.7	2,234	872	3,106	30.6
Employee (Private Sector)			4,591	45.7	2,870	1,245	4,115	40.6
Self-Employed/Employer and Workers in Family Farm or Business			2,073	20.6	1,904	1,016	2,920	28.8
Total			**10,056**	**100.0**	**7,008**	**3,133**	**10,141**	**100.0**
Occupation								
Professional, Technical, and Related Workers	1,148	534	1,682	16.7	991	555	1,546	15.2
Administrative, Executive, and Managerial Worke	247	18	265	2.6	352	84	436	4.3
Clerical and Related Workers	428	474	902	9.0	534	831	1,365	13.5
Sale Workers	281	220	501	5.0	212	132	344	3.4
Service Workers	825	497	1,322	13.1	1,155	532	1,687	16.6
Agricultural and Related Workers/Fishermen	2,067	62	2,129	21.2	1,838	241	2,079	20.5
Production Workers, Transport Equipment Operators, and Laborers	2,335	914	3,249	32.3	1,780	691	2,471	24.4
Not Reported	4	2	6	0.1	146	67	213	2.1
Total	**7,335**	**2,721**	**10,056**	**100.0**	**7,008**	**3,133**	**10,141**	**100.0**
Industry								
Agriculture and Fishery	2,080	70	2,150	21.4	1,867	247	2,114	20.8
Mining and Quarrying	2		2	0.0				
Manufacturing[a]	84	861	945	9.4	81	680	761	7.5
Electricity, Gas, and Water	78	4	82	0.8	242	16	258	2.5
Construction	1,043	33	1,076	10.7	834	14	848	8.4
Wholesale and Retail Trade	753	641	1,394	13.9	364	424	788	7.8
Transportation, Storage, and Communication	482	55	537	5.3	659	104	763	7.5
Finance, Insurance, Real Estate, and Business Services	660	173	833	8.3	305	254	559	5.5
Community, Social, and Personal Services[b]	2,151	884	3,035	30.2	2,493	1,310	3,803	37.5
Not Reported/Stated	2		2	0.0	163	84	247	2.4
Total	**7,335**	**2,721**	**10,056**	**100.0**	**7,008**	**3,133**	**10,141**	**100.0**

[a] The majority of women under the manufacturing industry groups are engaged in handicraft.

Continued on next page

[b] Includes service workers, government officials, professionals, technical, and related workers like the medical workers and teachers.

Table A3.1—*Continued*

Item	1988 Male	1988 Female	1988 Total	1999 Male	1999 Female	1999 Total
Resident Population	22,181	21,199	43,380	26,026	24,814	50,840
Annual Growth Rate (%)			4.3			1.5
Under 15 (%)			51.0			42.9
Urban (%)			64.5			65.2
Density Per Square Mile (persons)			619			726
Natural Increase Rate (%)			4.03			3.69
Number of Households			4,923			6,478
Average Household Size (persons)			8.8			7.8
Migration						
United States of America						6,560
Health						
Crude Birth Rate			49.2			41.8
Crude Death Rate			8.9			4.9
Total Fertility Rate			7.23			5.71
Infant Mortality Rate	58.5	55.3	56.9	41.4	32.4	37
Under 5 Mortality Rate			93			48
Life Expectancy at Birth	59.6	62.6	61.04	65.7	69.4	67.5
Education						
Total Enrollment						
Primary				5,878	5,505	11,383
Secondary				1,281	1,305	2,586
Gross Enrollment Rate (%)						
Elementary						115.0
High School						37.6
Literacy Rate (%)	91.4	89.9	90.7	96.8	97.2	97.0

Sources: 1988 Census of Population and Housing; 1994 Multi-Subject Household in the Marshall Islands; 1999 Census of Population and Housing; 2001 Statistical Abstract.

Table A3.2: Source of Income of Households (1999)

Sources of Income	Urban No. of Households	Urban %	Outer Islands No. of Households	Outer Islands %	Total No. of Households	Total %
Wages and Salaries	3,776	60.8	929	30.2	4,705	50.7
Net Receipts from Business/Profession	590	9.5	1,313	42.7	1,903	20.5
Commissions, Tips, Bonuses, Allowances	273	4.4	53	1.7	326	3.5
Dividends, Net Rental, Royalty, Income from Estates, Trusts	335	5.4	81	2.6	416	4.5
Security, Retirement, Survivor, and Disability Pensions	942	15.2	337	11.0	1,279	13.8
Remittances from Abroad/Domestic	90	1.4	33	1.1	123	1.3
Others	207	3.3	326	10.6	533	5.7
Total	**6,213**	**100.0**	**3,072**	**100.0**	**9,285**	**100.0**

Note: Because many households received income from mutiple sources, the number of households reported is greater than the household population.

Income Groups	Urban No. of Households	Urban %	Outer Islands No. of Households	Outer Islands %	Total No. of Households	Total %
No Income	8	0.2	1	0.0	9	0.1
Less than $1,000	72	1.7	797	36.5	869	13.4
$1,000 to $2,999	307	7.2	598	27.4	905	14.0
$3,000 to $4,999	553	12.9	205	9.4	758	11.7
$5,000 to $6,999	510	11.9	208	9.5	718	11.1
$7,000 to $9,999	627	14.6	159	7.3	786	12.1
$10,000 to $12,999	524	12.2	83	3.8	607	9.4
$13,000 to $15,999	363	8.5	33	1.5	396	6.1
$16,000 to $18,999	276	6.4	18	0.8	294	4.5
$19,000 to $29,999	531	12.4	31	1.4	562	8.7
$30,000 to $49,999	353	8.2	9	0.4	362	5.6
$50,000 to $69,999	96	2.2	7	0.3	103	1.6
$70,000 and over	34	0.8	0	0.0	34	0.5
Not Reported	39	0.9	36	1.6	75	1.2
Total	**4,293**	**100.0**	**2,185**	**100.0**	**6,478**	**100.0**

Median Household Income for RMI = $6,839.93

RMI = Republic of the Marshall Islands.

Source: 1999 Census of Population and Housing.

Table A3.3a: Characteristics of Marshalese Migrant Population to Hawaii and Arkansas

Item	NW Arkansas 2001[a]		Hawaii/Guam/CNMI 1997/98[b]	
	No.	%	No.	%
Total Surveyed	541		2,472	
Gender				
Male	294	54.3	1,169	47.3
Female	247	45.7	1,303	52.7
Age			2,472	
Less than 15 Years	194	35.9	838	33.9
15 to 29 Years	242	44.7	1,057	42.8
30 to 44 Years	75	13.9	351	14.2
45 to 59 Years	24	4.4	160	6.5
60 Years and Over	6	1.1	66	2.7
Educational Attainment				
Surveyed Population 25 Years and Over	201		840	
No School Completed	12	6.0	3	0.4
Less than High School Graduate	58	28.9	442	52.6
High School Graduate or Higher	131	65.2	395	47.0
Bachelor's Degree or Higher	3	1.5	8	1.0
Reasons for Migration to US				
Employment	182	33.6		
Spouse of Employed Person	26	4.8		
Dependent of Employed Person	124	22.9		
Education/Training	87	16.1		
Health/Medical Reasons	6	1.1		
Other Reasons	10	1.8		
Not Specified/Applicable	106	19.6		
Remittances				
Total Housing Units Surveyed	78		537	
Yes, Remitted Funds to RMI Last Year	41	52.6	139	25.9
$999 or less	21	26.9		
$1000 to 4999	19	24.4		
$5000 to $9999		0.0		
$10000 or more	1	1.3		
No, Did Not Remit Funds to RMI Last Year	37	47.4	398	74.1
Mean Annual Overseas Remittances	$1,892		$1,035	

CNMI = Commonwealth of Northern Marianas Islands, NW = northwest, RMI = Republic of the Marshall Islands, US = United States.

[a] Based on aggregated data from surveys conducted in 1997 and 1998 on the communities in Hawaii, Guam, and CNMI.

[b] Based on pilot survey conducted in late 2001 on the community in Northwest Arkansas.

Table A3.3b: Year of Entry of Marshallese Migrants to Arkansas, CNMI, Guam, and Hawaii

Country	Born in this Area	Year Migrated to Current Residence: Before 1990	1990/91	1992/93	1994/95	1996–1997/98	1999/01	Total
Commonwealth of Northern Marianas Islands (CNMI)[a]	33	23	8	0	16	12		92
Guam[a]	13	7	32	16	46	11		125
Hawaii[a]	228	298	220	307	561	641		2,255
Northwest Arkansas[b]	89 c	2	11	4	38	141	256	541

CNMI = Commonwealth of Northern Marianas Islands.

[a] Based on aggregated data from surveys conducted in 1997 and 1998 on the communities in CNMI, Guam, and Hawaii.

[b] Based on pilot survey conducted in late 2001 on the community in Northwest Arkansas.

Table A3.4: Primary Production by Households for Own Consumption (1995–1999)

	1995		1996		1997		1998		1999	
Item	**Quantity Short Tons**	**Value (US$)**	**Quantity Short Tons**	**Value (US$)**	**Quantity Short Tons**	**Value (US$)**	**Quantity Short Tons**	**Value (US$)**	**Quantity Short Tons**	**Value (US$)**
Agricultural	**2,370**	**1,215,763**	**2,468**	**1,301,704**	**2,564**	**1,372,425**	**2,651**	**1,418,073**	**2,703**	**1,447,707**
Banana	158	90,491	164	96,745	170	102,065	176	105,545	179	107,750
Breadfruit	1,155	546,371	1,197	583,226	1,238	612,095	1,280	632,967	1,306	646,196
Pandanus	105	48,109	109	51,439	112	53,760	116	55,593	118	56,754
Coconuts (all types)	815	357,739	856	385,424	898	410,800	928	424,808	947	433,686
Taro	105	140,320	109	150,035	112	157,244	116	162,606	118	166,004
Other Vegetables	32	15,360	33	16,315	34	16,830	35	17,403	35	17,766
Fruits	—	17,373	—	18,520	—	19,631	—	19,151	—	19,551
Meat	**813**	**1,713,471**	—	**1,889,305**	—	**2,050,540**	—	**1,953,730**	—	**2,086,582**
Pork	591	1,200,785	—	1,354,200	—	1,500,453	—	1,400,378	—	1,495,603
Chicken	222	512,686	—	535,105	—	550,087	—	553,352	—	590,979
Fish/Shellfish	**1,521**	**3,238,828**	**1,593**	**3,729,126**	—	**3,747,476**	**1,647**	**3,856,288**	**1,758**	**3,998,969**
Fish	1,521	3,168,096	1,593	3,655,848	—	3,672,000	1,647	3,780,512	1,758	3,920,390
Shellfish/Crabs	—	70,732	—	73,278	—	75,476	—	75,776	—	78,579
Item	**Number**	**Value (thousands)**	**Number**	**Value (thousands)**	**Number**	**Value (thousands)**	**Number**	**Value (thousands)**	**Number**	**Value (thousands)**
Livestock	**69,607**	**3,913**	**71,030**	**4,094**	**70,069**	**4,158**	**71,964**	**4,368**	**104,341**	**4,305**
Pig	12,222	3,721	13,216	3,899	13,341	3,962	13,159	4,205	14,778	4,144
Poultry	57,385	192	57,814	195	56,728	196	58,805	163	89,563	161

— = not available.

Source: 2001 Statistical Abstract.

SUMMARY OF FOLLOW-UP ACTIONS

Action	Responsibility	Time Frame
To help implement FFMP, and develop sound fiscal policy, local capacity should be developed to prepare a GFS presentation of the budget and fiscal position. The capacity should include the ability to make projections based on trends and alternative policy interventions.	Department of Finance and EPPSO	3 months
Based on a GFS format, a long-term fiscal policy should be developed to anticipate real reductions in Compact flows that can be sustained without periodic and painful fiscal adjustments.	Department of Finance and EPPSO	6 months
To support the development of a long-term fiscal policy, the external debt position and debt service capacity should be reviewed.	Department of Finance and EPPSO	6 months
To provide an efficient and modern tax system, efforts started through the FFMP to improve tax administration should be built on, and sustained.	Department of Finance and EPPSO	12 months
Once tax administration has been strengthened, the issue of tax reform and the introduction of a VAT should be reviewed again.	Department of Finance and EPPSO	12–36 months

EPPSO = Economic Policy, Planning, and Statistics Office; FFMP = Fiscal and Financial Management Program; GFS = government finance statistics; VAT = value-added tax.