

**PROGRAM PERFORMANCE AUDIT REPORT**

**ON THE**

**PUBLIC SECTOR REFORM PROGRAM  
(Loan 1520-FSM[SF])**

**IN THE**

**FEDERATED STATES OF MICRONESIA**

**September 2003**

## **CURRENCY EQUIVALENTS**

The Federated States of Micronesia uses the US dollar as its currency.

## **ABBREVIATIONS**

ADB	–	Asian Development Bank
COS	–	country operational strategy
DEA	–	Department of Economic Affairs
DFA	–	Department of Finance and Administration
EMPAT	–	economic management and policy advisory team
EPIC	–	Economic Policy Implementation Council
ERS	–	early retirement scheme
FSM	–	Federated States of Micronesia
FY	–	fiscal year
GDP	–	gross domestic product
HRD	–	human resource development
OEM	–	Operations Evaluation Mission
PCR	–	program completion report
PIDMC	–	Pacific Island developing member country
PPAR	–	program performance audit report
PSDP	–	private sector development program
PSRP	–	public sector reform program
PSIP	–	public sector investment program
RMI	–	Republic of Marshall Islands
RRP	–	Report and Recommendation of the President
SDR	–	special drawing rights
TA	–	technical assistance
US	–	United States

## **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.

## CONTENTS

	Page
BASIC DATA	ii
EXECUTIVE SUMMARY	iii
I. BACKGROUND	1
A. Purpose of the Report	1
B. The Setting	1
C. Rationale	2
D. Formulation	2
E. Objectives and Scope	3
F. Financing Arrangements	3
G. Implementation Arrangements	4
H. Program Completion Report	4
I. Operations Evaluation	4
II. IMPLEMENTATION PERFORMANCE	4
A. Effectiveness of Design	4
B. Policy Reform Measures	7
C. Effectiveness of Technical Assistance	13
D. Compliance with Covenants	16
III. PROGRAM OUTCOMES	16
A. Achievement of Purpose	16
B. Sustainability	18
C. Socioeconomic Impact	19
D. Environmental Impact	21
IV. OVERALL ASSESSMENT	21
V. CONCLUSIONS	22
A. Lessons	22
B. Key Issues for the Future	23
C. Follow-Up Actions	24
APPENDIXES	
1. Policy and Institutional Reform Matrix	26
2. Compliance with Loan Covenants	36
3. Key Provisions of Compact II	42
4. Key Indicators	44
5. Profile of Early Retirees	56
6. Socioeconomic Impact Assessment	57

**BASIC DATA**  
**Public Sector Reform Program (Loan 1520-FSM[SF])**

**Technical Assistance/Institution Building**

<b>TA No.</b>	<b>TA Name</b>	<b>Type</b>	<b>No. of Person-Months</b>	<b>Amount (\$'000)</b>	<b>Approval Date</b>
2294	Expansion of the Economic Management Policy Advisory Team (Supplementary)	advisory	23	540	29 Apr 1997
2786	Investment Promotion and Financial Sector Review	advisory	10	380	29 Apr 1997

<b>Key Program Data (\$ million)</b>	<b>As per ADB Loan Documents</b>	<b>Actual</b>
Total Program Cost	18.00	17.68
ADB Loan Amount/Utilization	18.00	17.68

<b>Key Dates</b>	<b>Expected</b>	<b>Actual</b>
Fact-Finding		18 Aug–6 Sep 1996
Follow-Up Fact-Finding		18–22 Oct 1996
Appraisal		23 Nov–5 Dec 1996
Loan Negotiations		25 Mar–3 Apr 1997
Board Approval		29 Apr 1997
Loan Agreement		23 May 1997
Loan Effectiveness	21 Aug 1997	27 Jun 1997
First Tranche Release	Aug 1997	5 Aug 1997
Second Tranche Release	Mar 1998	20 Nov 1998 (part) 14 Jun 1999 (final)
Program Completion	31 Jul 1999	31 Dec 1999
Loan Closing	31 Mar 1999	14 Jun 1999
Months (effectiveness to completion)	23	30

**Borrower** Federated States of Micronesia

**Executing Agency** Department of Finance, National Government

<b>Type of Mission</b>	<b>No. of Missions</b>	<b>No. of Person-Days</b>
Reconnaissance	1	21
Fact-Finding	2	59
Appraisal	1	13
Program Review	3	80 <sup>1</sup>
Program Completion	1	27
Operations Evaluation <sup>2</sup>	1	66

ADB = Asian Development Bank, TA = technical assistance.

<sup>1</sup> This may overestimate the number of days spent on review as the missions may have covered other tasks.

<sup>2</sup> Operations Evaluation Mission comprised R.K. Leonard (Senior Evaluation Specialist/Mission Leader), M.J. Moriarty (Public Expenditure Management Specialist/International Consultant) and J.G. Tubadeza (Senior Evaluation National Officer/Field Social Impact Assessment). P. Schoeffel (Social Impact Assessment Specialist) provided home office support to the Senior Evaluation National Officer.

## EXECUTIVE SUMMARY

The Federated States of Micronesia (FSM) consists of four states (Chuuk, Kosrae, Pohnpei, and Yap) spread over a 3,000 kilometer stretch of the North Pacific Ocean. Formerly a United Nations Trust Territory, the people of the FSM voted in 1978 for independence in free association with the United States (the former trustee). They adopted a constitution, based on the United States model, that provides for three branches of government—executive, legislative and judicial. There are also three levels of government—national (or federal), state, and municipal. The states have a great deal of control over their own affairs while the role of the National Government is constitutionally restricted to areas such as foreign affairs and those beyond the power of the states to control.

In 1979, the FSM signed a Compact of Free Association (the Compact) with the United States. This agreement—which came into effect in 1986—provided generous, relatively untied and partly inflation-indexed grant assistance to the country for a period of 15 years, extendable by 2 years to 2003. To progressively increase the independence of the country, the Compact funding included two “step-downs” after the fifth and tenth years. There were very few adjustment problems associated with the first step-down, but by the mid-1990s the FSM had growing problems and was facing an uncertain future. For instance, the high level of external transfers had distorted the economy, which had a disproportionately large public sector and a small productive sector. Also, the second “step-down” coupled with borrowing against future Compact receipts had created a financial crisis in several of the states (especially in Chuuk). Finally, there was considerable uncertainty about the future amount of external assistance likely to be forthcoming from the United States or elsewhere following the end of the Compact. Given these concerns, a consensus started to emerge that changes were needed.

In 1995, the FSM asked the Asian Development Bank (ADB) to coordinate external support and to provide technical assistance (TA) for economic management and policy advice. In response, ADB funded an economic management and policy advisory team (EMPAT). The EMPAT team conducted an analysis of the economic situation and helped facilitate a series of economic summits that endorsed a comprehensive reform strategy. A central element of this strategy involved reducing the size and cost of government. To achieve this, the authorities sought a loan from ADB to largely, but not exclusively, fund the cost of compensation to public servants retrenched under an early retirement scheme. In April 1997, the Board of ADB approved a loan for \$18 million (equivalent) from the Asian Development Fund in support of a public sector reform program (PSRP) in the FSM.

The goal of the PSRP was the transformation and development of a more efficient FSM economy. Its purpose had two dimensions: (i) reforming and reducing the size of the public sector to adjust to declining external resource transfers, and (ii) shifting the balance of economic activity away from the public to the private sector. Five outputs were specified (i) reduced size and operating cost of the civil service; (ii) increased domestic revenue generation; (iii) restructured government operations and public enterprises, with the divestiture of some of the latter; (iv) successful mitigation of negative social and economic impacts of the adjustment in public expenditure; and (v) improved conditions for private sector development.

The loan was to be disbursed in two tranches (\$10 million and \$8 million) with the second tranche dependent on the national and at least two of the state governments meeting three specific conditions along with sufficient general progress in implementing the PSRP. A partial second tranche was released 8 months behind schedule with the balance released to

Chuuk and Pohnpei states some 7 months later. The loan closed about 2 months behind schedule in June 1999.

The PSRP design did not give equal weight to the two dimensions of the purpose—fiscal stabilization and economic restructuring. Around 60% of the conditions and most of the financial resources were directed at the stabilization objective. This was understandable given the pressing nature of the fiscal problems facing the country, particularly in Chuuk.

A reduction in the number and cost of core public service personnel in fiscal year (FY)1997 and FY1998 was the most important part of the PSRP. The main mechanism for this reduction was the early retirement scheme. Performance in meeting the targets for staff and wage bill reduction varied considerably among governments. By the end of the program period, two states had exceeded their workforce reduction targets (Kosrae and Yap, both by 6%) while the other governments fell short of their targets (Chuuk by 8%, Pohnpei by 12%, and the National Government by 17%). Performance against targets for cost reductions proved more difficult to meet. Only Yap exceeded its cost reduction target (by 6%). All other governments fell short (Chuuk by 20%, Kosrae by 12%, Pohnpei by 9%, and the National Government by 11%). For the FSM as a whole neither total target was fully met. However, significant reductions of 22% in staff numbers (against a target of 27%) and 28% in wage bill costs (against a target of 35%) were achieved. The annual cost savings amounted to about \$16 million compared to the \$18 million PSRP loan.

An improved revenue-generation effort was also required under the PSRP. The policy matrix set individual targets for improved revenue collection by each state and the National Government. Revenue targets were met or exceeded by the end of the program period. Consolidated tax revenue was 27% higher on average in the 4-year period FY1998–FY2001 than in the previous 4 years.

A number of conditions addressed the need for a restructuring of government operations and public enterprises. There was only a limited strategic dimension to the downsizing. The creation of utility corporations (still under public ownership) and the institution of user charges were the main results from this component of the PSRP.

It was recognized that the PSRP was likely to have some negative impacts on employment, and therefore income, in the short to medium term, but that adjustment was necessary to avoid an even worse situation in the face of declining external revenue. The PSRP's effort to mitigate the negative social and economic impacts of the reform, principally through separation payments made to early retirees, was relatively successful, although not always in the way intended. While it had been hoped that many would use the payments to start businesses, this did not happen to any significant extent. Rather, people used the money to retire debt, fund consumption, or emigrate. The additional consumption and remittances from those that emigrated supported economic activity. Importantly, the payments to the retirees helped ensure that the downsizing was politically acceptable.

The PSRP also envisaged some moves to foster private sector development to fill the void left by a reduction in public sector expenditure. The main achievement was the passage of new foreign investment legislation. However, due to a range of constraints beyond the scope of the PSRP, there has as yet only been a limited response from the private sector.

The fiscal stabilization objective was largely achieved, although there has been some reversal of the gains made in Chuuk and Kosrae states. However, these reversals, which were

made possible by the so-called “bump-up” funds available for the 2-year transitional period between the first Compact and a recently concluded second agreement, are expected to be temporary. Less progress was made with the economic restructuring objective and further reforms are required in this area. However, the uncertainty created by fiscal imbalance and the level of future external revenue flows has now been substantially resolved. This should provide a more favorable environment for investment. The most important outstanding issue is to reduce the gap between public service and private sector wage rates in order to encourage a shift of resources from the public to private sectors.

The reform program has had some negative social impacts in terms of income, gender, and (in the case of education) service quality. Nonetheless, the FSM was on an unsustainable path and the impact of not reforming was likely to be even more severe.

The PSRP is rated as successful. It was judged to be highly relevant, efficacious, and efficient with likely sustainability and significant other impacts. The sustainability is made more certain by the terms and conditions of the recently concluded second Compact agreement under which the funds to be made available will be much more tightly controlled and based on performance.

The effort put into consensus building in such a complex bureaucratic and political context was a major contributor to the success of the PSRP. The evaluation also assessed that the EMPAT TA played a fundamental role in generating and maintaining support for the reform process.

The EMPAT TA had three objectives—provision of high-quality policy advice to the five governments, monitoring and reporting on progress of the PSRP, and developing a domestic capability to carry out these tasks without the need for expatriate input in the medium term. There is little doubt that the EMPAT TA was highly successful in achieving the first two objectives. The objective of self-sufficiency is yet to be attained. Initially, the EMPAT consultants worked with nominated counterparts. However, it was soon apparent that this approach would not produce the desired level of competence in policy analysis and advice. An alternative approach was adopted of working with young graduates to assess their suitability for further training, provision of postgraduate training in economics, and incorporation of the graduates into a well-functioning policy unit supported by consultants. While this approach takes time and is resource intensive, the results have been much better—both in terms of numbers trained in depth and their level of resulting competence—than what might be termed the “counterpart approach” more commonly used in TAs. Potentially, this is the most important lesson emerging from the evaluation. It is one that could lead to a fundamental reconsideration of the strategy for developing skills and competence using TA resources and/or of the objectives set for such capacity building.

## I. BACKGROUND

### A. Purpose of the Report

1. This program performance audit report (PPAR) assesses the performance of a public sector reform program (PSRP) supported by a loan<sup>1</sup> and two technical assistance (TA) grants<sup>2</sup> provided by the Asian Development Bank (ADB) to the Government of the Federated States of Micronesia (FSM). In deriving a performance rating for the PSRP and its associated TAs, the PPAR fulfils an accountability function. It also identifies issues, lessons, and recommendations designed to improve the performance of ongoing and future operations in the FSM and elsewhere.

### B. The Setting

2. The geographic setting, model of government, and development history are important contextual factors for an evaluation of the PSRP. The FSM is a federation of four states (Chuuk, Kosrae, Pohnpei, and Yap), each with its own government, language(s), culture, and identity. The National Government operates out of Pohnpei state.<sup>3</sup> More than 600 islands scattered over a distance of around 3,000 kilometers from west to east provide home to just over 100,000 people. While the means of communication, in particular telecommunication, have improved over recent years, the physical isolation of the country, and of the states from each other, pose particular challenges for the governments and the development financing institutions working with them.

3. The four states of the FSM were formerly a part of the United Nations Trust Territory of the Pacific under United States (US) trusteeship. In 1978, the FSM people voted for independence in free association with the US and a constitution based upon the US model, which provides for three branches of government—executive, legislative, and judicial. There are also three levels of government—national, state, and municipal while traditional governance is also important. The National Government's role is limited to certain constitutionally defined areas such as foreign affairs and those beyond the power of the states to control. The four states have a great deal of control over their own affairs, including the power to make external contracts. State governments also have executive, legislative, and judicial branches and are responsible for areas such as resource and development (agriculture, fisheries, forestry, etc.), health, education, public safety, public works, finance, planning and budget, and personnel. The elected state legislatures, like the National Congress, are unicameral (apart from Chuuk, which has a house of representatives and a senate). Generating and maintaining ownership of reform programs and providing effective support and supervision for loans and TAs are more challenging and time-consuming tasks in this context. Importantly, considerable effort must be put in at the state level.

4. The pre-reform problems of the FSM have their roots in welfare-oriented public policies dating back to the 1960s. US policy in the Trust Territory of Micronesia successfully arrested population decline and modernized living standards. However, over the next 30 years

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<sup>1</sup> ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Federated States of Micronesia for the Public Sector Reform Program*. Manila.

<sup>2</sup> ADB. 1997. *Technical Assistance to the Federated States of Micronesia for the Expansion of the Economic Management Policy Advisory Team (Supplementary)*. Manila, and ADB. 1997. *Technical Assistance to the Federated States of Micronesia for an Investment Promotion and Financial Sector Review*. Manila.

<sup>3</sup> As the FSM uses the term national rather than federal government, this convention has been adopted throughout this report.



dependence on public sector employment and imported goods discouraged domestic production and encouraged outer island migration and urbanization, so that by the 1990s most of the population was concentrated on the main islands of each state. From the early 1970s to 1989 most inhabitants of the FSM qualified for US federal welfare programs for the poor that provided, among other benefits, food stamps, and free meals for school children and the elderly. The legacy was public expectation and political demands at the state level that high levels of government expenditure would continue after independence.<sup>4</sup>

### C. Rationale

5. In 1979, the FSM signed a Compact of Free Association (the Compact) with the US, which became effective in 1986. This arrangement provided generous grant assistance to the FSM for a period of 15 years to 2001, extendable to 2003. The aim was to strengthen the state and national economies over this period and to make them more independent. To this end, the Compact funding was designed to decline over the period with two “step-downs” after the fifth and tenth years.<sup>5</sup> By the mid-1990s, the FSM was facing an uncertain future and had growing problems—for example (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 in several of the states (especially in Chuuk); and (iii) there was considerable uncertainty about the future amount of external assistance likely to be forthcoming from the US or elsewhere following the end of the Compact. Given these concerns, a consensus started to emerge that changes were needed.

### D. Formulation

6. In 1995, the FSM asked ADB to coordinate external support and to provide TA for economic management and policy advice. In response, ADB funded an economic management and policy advisory team (EMPAT), which comprised two resident advisors and a number of short-term consultants.<sup>6</sup> EMPAT prepared an economic situation report and supported the FSM’s participation in consultative group meetings of development partners. ADB hosted the first consultative group meeting on 6 December 1995 in Manila. EMPAT also undertook preparatory work and facilitated a participatory process of economic summits in each state and at the national level. As a result, the Government was able to present to the first consultative group a wide-ranging economic policy reform strategy, which had been endorsed at the national summit held the previous month.

7. A central element of the reform strategy involved reducing the size and cost of government. To achieve this, the authorities sought a loan from ADB to largely, but not exclusively, fund the cost of the compensation to the staff retrenched under an early retirement

<sup>4</sup> Schoeffel, P. 1992. Food and Health and Development, in the Pacific Islands: Policy Implications for Micronesia. *ISLA Journal of Micronesian Studies*. Vol.1.

<sup>5</sup> The annual block grants were \$60 million for fiscal year (FY)1987–FY1991, \$51 million for FY1992–FY1996 and \$40 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 FY2002 and FY2003. These are known as the “bump-up” funds. A new Compact treaty (Compact II) was signed in May 2003 and is expected to come into effect on 1 October 2003.

<sup>6</sup> ADB. 1995. *Technical Assistance to the Federated States of Micronesia for a Policy Advisory Team for Economic Management*. Manila.

scheme (ERS). An ADB reconnaissance mission visited the FSM in May/June 1996 and fact-finding missions followed in August and October 1996. An appraisal mission was conducted in November/December 1996. An important feature of program processing was the effort put into involving the state governments as well as the National Government through repeated visits to each state and a considerable degree of customization to individual government circumstances. Loan negotiations were conducted in March/April 1997 and the PSRP loan was approved on 29 April 1997 (footnote 1). Two TAs were also approved (footnote 2).

## **E. Objectives and Scope**

8. The goal of the PSRP was the transformation and development of a more efficient FSM economy. Its purpose had two dimensions: (i) reforming and reducing the size of the public sector to adjust to declining external resource transfers, and (ii) shifting the balance of economic activity away from the public to the private sector. Five outputs were specified (i) reduced size and operating cost of the civil service; (ii) increased domestic revenue generation; (iii) restructured government operations and public enterprises, with the divestiture of some of the latter; (iv) successful mitigation of negative social and economic impacts of the adjustment in public expenditure; and (v) improved conditions for private sector development.

9. The PSRP was comprehensive in its scope. The policy matrix included 55 conditions although this figure gives an incorrect impression about the number of distinct conditions, as many of them were variations customized to the specific circumstances of each of the five governments. Of the 55 conditions, 19 prescribed measures to reduce the number and cost of public service personnel, 3 related to other cost reductions, 11 concerned revenue-raising measures, 8 related to the restructuring of government departments and public enterprises, 5 involved measures to mitigate the social and economic impact of the reforms, and 9 were designed to foster the private sector (Appendix 1 contains the policy matrix).

## **F. Financing Arrangements**

10. The loan was designed to finance the adjustment costs associated with the reform program—principally, the separation payments of the ERS. Its approved amount was SDR12,979,000 (equivalent to \$18 million) from the Asian Development Fund. The funds were to be disbursed in two tranches of \$10 million and \$8 million, respectively, and the counterpart funds were to be allocated among the state and national governments in line with their estimated individual adjustment costs. The first tranche was disbursed on 5 August 1997.

11. The second tranche was originally targeted for release by March 1998 subject to the National Government and at least two of the states fulfilling three specific conditions: (i) achievement of the downsizing targets, (ii) enactment of a new Foreign Investment Act by the National Government and corresponding legislation by the states, and (iii) enactment by the National Government of the Customs Law and amendment of the Gross Revenue Tax Law to remove tax disincentives on exports. In addition, the national and state governments were required to achieve and maintain sufficient general progress in carrying out the PSRP. The release of the second tranche was delayed because of delays in meeting the release conditions. A partial second tranche of \$4 million was released to the National Government and to the Yap and Kosrae state governments on 20 November 1998, and a final part of the second tranche of \$3.68 million was released to the Chuuk and Pohnpei states on 14 June 1999.

12. The national and state governments established special accounts, as required by a loan covenant (Appendix 2), into which they set aside funds from savings on salaries and wages

from the reforms over the remaining years of Compact I. Only Chuuk state has not yet made a full payment. Funds not required for meeting ERS payments and other program-related expenditures were also placed in these accounts. These funds and the investment returns from them will more than meet loan repayment requirements.

## **G. Implementation Arrangements**

13. The FSM Department of Finance and Administration was the executing agency for the PSRP loan and was responsible for its overall implementation. At the state level, the office of each governor was responsible for overseeing implementation of the respective state reform programs. A public sector reform committee in each state, assisted by the EMPAT team, was responsible for devising the downsizing strategy and monitoring its implementation.

## **H. Program Completion Report**

14. The program completion report (PCR)<sup>7</sup> rated the PSRP loan as generally successful.<sup>8</sup> It indicated that it had a high level of local ownership and was relatively successful in reducing the cost and size of the public sector. According to the PCR, insufficient attention was paid to the strategic prioritization and functional analysis in restructuring, reform of public entities (apart from public utilities), and private sector development. The PCR noted that the TA provided good policy advice and helped monitor the status of matrix conditionalities and economic performance. According to the PCR, the commitment of the state governments in carrying out the agreed reforms was impressive.

## **I. Operations Evaluation**

15. An operations evaluation mission (OEM) visited the FSM in May 2003 to evaluate the performance of the PSRP and associated TAs. The team visited all four states. Social impact field assessment was carried out in the two larger states (Pohnpei and Chuuk) to allow for more in-depth investigation. The OEM met with current and former staff of the national and four state governments, representatives of the private sector, nongovernment organizations, early retirees under the scheme, and consultants. A draft of the PPAR was circulated to the Government and within ADB. Comments were incorporated as appropriate.

# **II. IMPLEMENTATION PERFORMANCE**

## **A. Effectiveness of Design**

### **1. Consistency with Government and ADB Strategy**

16. ADB's strategy in effect at the time of the PSRP design was the 1994 Country Operational Strategy (COS),<sup>9</sup> which contained two basic premises—(i) the country had considerable potential for developing its fisheries, tourism, and agricultural resources; and (ii) it had a highly dependent economy because US funds provided about two-thirds of the national income. With the end of the Compact, the COS projected that real per capita income could decline from about \$1,050 in 1990 to \$350 in 2002. To avoid such a disaster, the strategy was

<sup>7</sup> ADB. 2000. *Program Completion Report for the Public Sector Reform Program in the Federated States of Micronesia*. Manila.

<sup>8</sup> Based on the previous three-category rating scale of generally successful, partly successful, or unsuccessful.

<sup>9</sup> ADB. 1994. *Country Operational Strategy for the Federated States of Micronesia*. Manila.

for ADB to help the FSM embark on a structural adjustment process so that the country could achieve greater economic self-reliance.

17. The COS gave considerable attention to the political economy aspects of the structural adjustment task. Three key elements were identified: (i) the division of power among the four states and the National Government; (ii) the need for current governments to take hard political decisions to avert problems that may arise a decade later; and (iii) the widespread belief that funds from the US or elsewhere would continue to flow undiminished for decades to come so there was no need for sacrifice at the time. The COS proposed a “novel role” for ADB of proactive leadership with special emphasis on aid coordination, together with support for structural adjustment and continued assistance to project finance and TA. ADB’s principal task was seen as ensuring “proper sequencing, the right timing and the guaranteeing of a well balanced set of development activities.” An important operational implication was the policy advisory role combining TA and “special policy-based missions” and an increased output of economic and sector work. The PSRP’s design was highly consistent with this strategy.

18. The updated ADB country strategy for the FSM (articulated in 2002) saw the immediate challenge as ensuring strong growth of the private sector, including divestment by the governments of certain commercially oriented activities.<sup>10</sup> Other areas of focus are (i) social sector development and reforms with an emphasis on outer islands; and (ii) good governance, including improved economic planning and budgeting systems and improved financial accountability. The PSRP remains relevant although perhaps less central to the current strategy.

19. The Government’s reform strategy was developed through a participatory national summit process, which engendered much broader understanding of the issues, not only in the executive and legislative branches but also in the wider community. As the reality of the Compact II provisions (Appendix 3) become apparent, the governments increasingly see that reforms carried out under the PSRP remain relevant to the country’s needs.

## **2. Adequacy of the PSRP Preparation**

20. The PSRP was generally well prepared. There was no project preparatory TA but to all intents and purposes, the EMPAT team filled this role. In fact, EMPAT provided a better approach than a separate preparatory TA might have done because the consultants, who had been present for some time, had carried out comprehensive analytical work. They had also developed good relationships with national and state government officials as well as with elected representatives, which is important but can be difficult to achieve in a TA of shorter duration. There was a high degree of local input and hence ownership, at least of the more important parts of the PSRP, and a good degree of customization to the specific needs of each government. One gap in the preparation was insufficient social analysis (para. 86).

## **3. Coherence, Logic, and Sufficiency of the Program**

21. The PSRP design did not give equal weight to the two dimensions of the purpose—fiscal stabilization and economic restructuring. Around 60% of the conditions and most of the financial resources were directed at the stabilization objective. This was understandable given the pressing nature of the fiscal problems facing the country, particularly in Chuuk. Also, fiscal stabilization contributes to private sector development by reducing business risk. As such, the

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<sup>10</sup> ADB. 2002. *Country Strategy and Program Update (2003–2005): Federated States of Micronesia*. Manila. Available at <http://www.adb.org/documents/csps/FSM/2002/default.asp?p=ctryfsm>.

sequencing of the reforms was appropriate. However, the PSRP design did not set specific targets or indicators for measuring progress in economic restructuring, which was a deficiency. Also, reform sequencing could have incorporated measures to produce some early political benefits—for example, moves designed to improve service quality.

22. Economic restructuring requires a change in relative prices. Given that the FSM uses the US dollar as its currency, it cannot control the exchange rate. The Compact funding has distorted the structure of the economy by raising wages in the public sector compared with wages in the private sector, thus constraining development of the latter. None of the conditions explicitly required a reduction in public sector wage rates to reduce the disparity between the public and private sectors (although the wording of the conditions did leave this approach open to the authorities). Given the lack of effective means for achieving serious economic restructuring, the time that such restructuring requires and the paucity of options and skills for viable private sector development, the most that can be said about the restructuring objective of the PSRP is that the FSM was expected to make a useful start toward creating an environment more favorable for private sector development.

23. It was inherently unlikely that former public servants would become private sector entrepreneurs without transition support services, and even then the assumption that many could make a successful transition was probably unrealistic. While provision for transition services for ERS retirees was included in the PSRP, the policy matrix did not allocate any clear accountability for this task nor was any assessment made of the ability of the five governments to provide such services to their former employees.

#### **4. Identification of Assumptions and Risks**

24. During design, three major risks were identified that could negatively affect the achievement of the PSRP's purpose: (i) a possible lack of expertise and institutional capacity to effectively implement the reform program, (ii) a possible lack of political will, and (iii) a failure of the private sector to respond as visualized. Continuation of the EMPAT team and provision of a supplementary TA (footnote 2) were seen as the way to mitigate the first risk, and indeed it was effective (para. 50). The second risk did occur to some extent as at least two pro-reform governors lost office to opponents who campaigned against the reform. In two states there was some reversal of the stabilization gains made (paras. 64–66). Notwithstanding this, FSM legislators showed a high degree of political will and a preparedness to take some hard decisions helped by the retrenchment payments, which reduced the political costs.

25. The third risk did eventuate and was not successfully mitigated—namely, the slow response of the private sector (para. 62).<sup>11</sup> In this regard, a factor that should have been identified was the likelihood that the socioeconomic conditions shaped by the public policy environment of the FSM for almost 30 years might partly frustrate the intent of increasing private sector activity. Based on evidence from Pacific Island developing member countries (PIDMCs), reducing public sector employment and remuneration is unlikely to lead to significantly increased domestic production and entrepreneurial activity. Rather, it is likely to increase migration, stimulating the growth of a remittance economy, with continued high levels of import dependence and low domestic productivity.<sup>12</sup>

<sup>11</sup> Further support to stimulate private sector development is being provided by the private sector development program (ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans to the Federated States of Micronesia for the Private Sector Development Program*. Manila [Program/Project Loans]).

<sup>12</sup> Schoeffel. 1996. *Sociocultural Issues and Economic Development in the Pacific Islands*. Asian Development Bank: Manila.

26. A significant assumption underpinning the design of the PSRP was that US funding to the FSM might be substantially reduced with the termination of the Compact I. Not all key politicians and officials accepted this assumption. The targets for recurrent cost reduction were in line with a reduction of around one third in the level of transfers prevailing over the FY1997–FY2001 period. In the event, had targets been fully met and given the outcome of the Compact II negotiations, the aggregate level of cost reduction would have been more than needed. However, given the failure to meet targets and some reversal in the gains made, the aggregate fiscal adjustment facing the FSM at the start of Compact II is not large. Furthermore, some of the politicians believed that it would be bad negotiating tactics to take actions in advance of Compact II negotiations that may indicate acceptance of cuts in future Compact funding.

## B. Policy Reform Measures

### 1. Reduction in the Size and Operating Cost of the Civil Service

27. A reduction in the number and cost of core public service personnel in FY1997 and FY1998 was the most important part of the PSRP. The main mechanism for this was the ERS, which was accompanied by a freeze on new recruitment. The personnel reduction targets and wage bill reduction targets for all five governments are shown in Tables 1 and 2. The targets were determined on the basis of an analysis of “surplus” staff but the actual downsizing was not tied to a strategic plan for a future public service focused on core activities.

**Table 1: Target Reductions in Staff Numbers by Government**

Government	Number		Change (%)
	1995	Target	
Chuuk	2,784	1,963	(29)
Kosrae	712	610	(14)
Pohnpei	1,316	952	(28)
Yap	940	660	(30)
National	642	507	(21)
<b>Total</b>	<b>6,394</b>	<b>4,692</b>	<b>(27)</b>

Source: Compiled by the Economic Management and Policy Advisory Team from government electronic records.

**Table 2: Target Reductions in Wage Bill by Government**

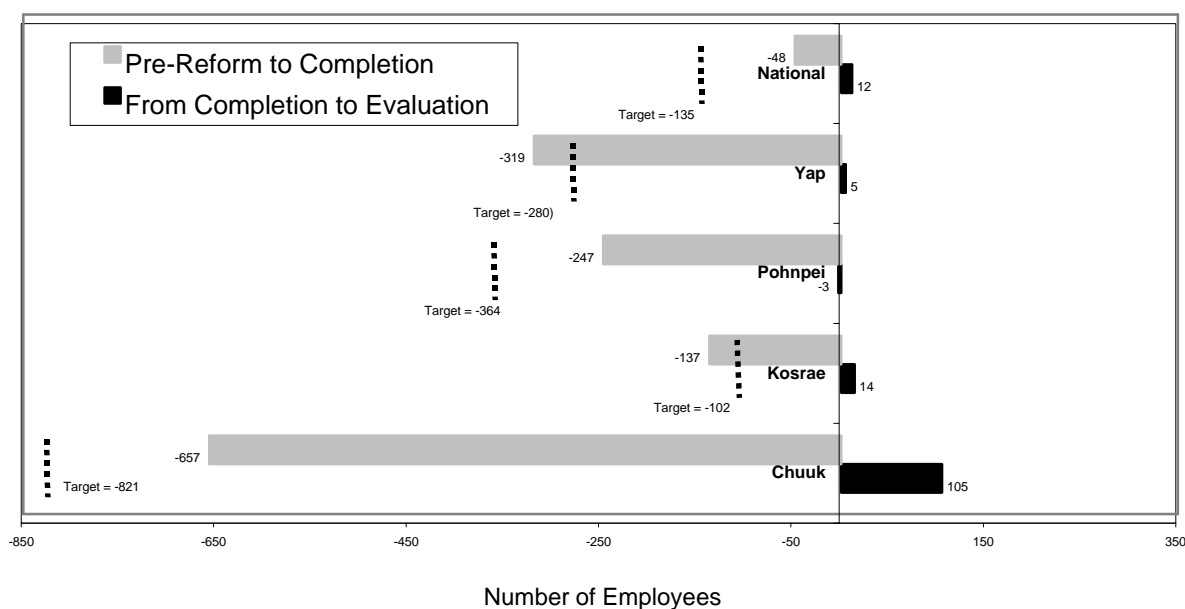
Government	Wage Bill <sup>a</sup>		Change %
	1995 (\$)	Target (\$)	
Chuuk	769,385	432,113	(44)
Kosrae	203,223	150,643	(26)
Pohnpei	605,454	383,671	(37)
Yap	245,990	173,505	(29)
National	367,262	290,290	(21)
<b>Total</b>	<b>2,191,314</b>	<b>1,430,222</b>	<b>(35)</b>

<sup>a</sup> Fortnightly wage bill.

Source: Compiled by the Economic Management and Policy Advisory Team from government electronic records.

28. Performance in meeting the targets for staff and wage bill reduction varied considerably among governments (Figure 1 and Figure 2, which show results by program completion and at evaluation—the latter revealing some reversals of gains made). By the end of the program period, two states had exceeded their workforce reduction targets (Kosrae and Yap, both by 6%) while the other governments fell short of their targets (Chuuk by 8%, Pohnpei by 12%, and the National Government by 17%). Performance against targets for cost reductions proved more difficult to meet. Only Yap exceeded its cost reduction target (by 6%). All other governments fell short (Chuuk by 20%, Kosrae by 12%, Pohnpei by 9%, and the National Government by 11%). For the FSM as a whole neither total target was fully met. However significant reductions of 22% in staff numbers (against a target of 27%) and 28% in wage bill costs (against a target of 35%) were achieved. The total cost savings amounted to \$15.8 million on an annual basis compared to the \$18 million PSRP loan.

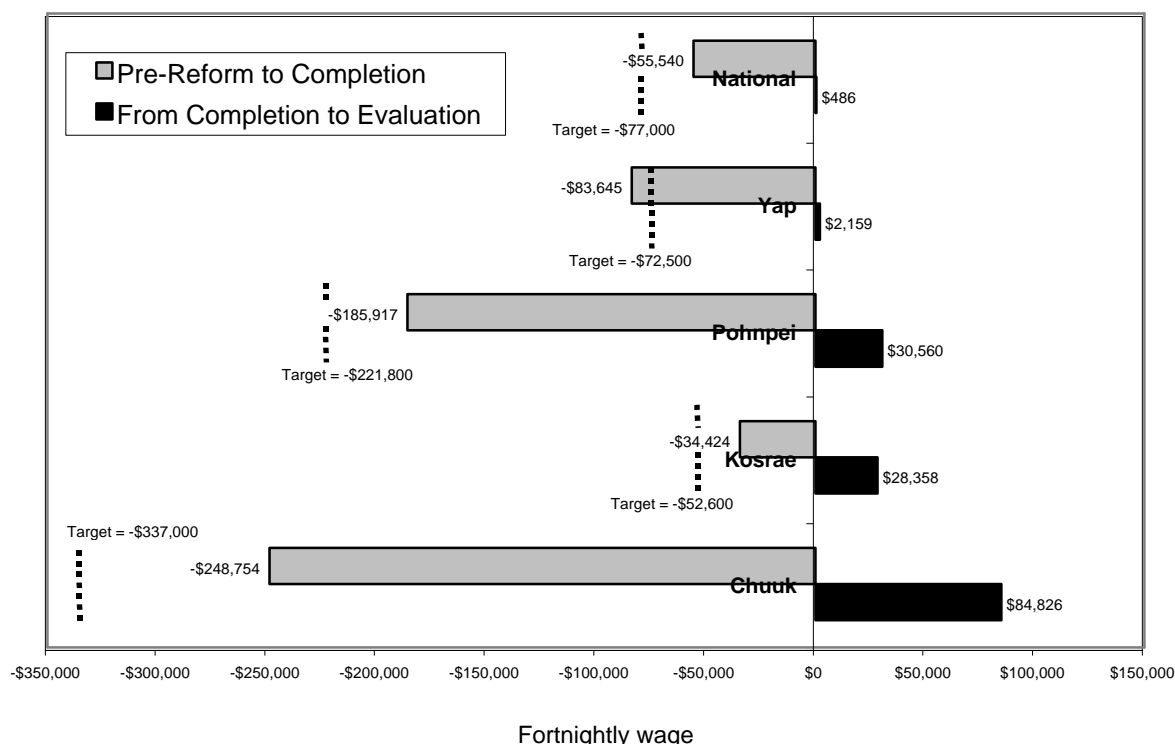
**Figure 1: Changes in Number of Government Employees at Completion and Evaluation**



Note: Recent figures for Chuuk adjusted up by 120 to account for presence of unauthorized contract workers.

Source: Based on figures compiled by the Economic Management and Policy Advisory Team and sourced from government payroll records.

**Figure 2: Changes in Government Personnel Costs**  
(bi-weekly wage bill)



Note: Recent figures for Chuuk adjusted up by \$19,200 to account for presence of unauthorized contract workers.

Source: Based on figures compiled by the Economic Management and Policy Advisory Team and sourced from government payroll records.

29. Other personnel costs were also reduced. Measures included a freeze on regular annual increments, promotions, and job reclassifications; a reduction in overtime payments; and a change in the leave system to prevent the accrual of sick and annual leave. One of the conditions required the Chuuk government to reduce working hours by 20% (by reducing the working week from 5 to 4 days), while Kosrae and Pohnpei were asked to reduce working hours by 12.5%. Pohnpei reduced the working fortnight to 64 hours while Kosrae, which was already on 64 hours, reduced it further to 56 hours. This technique for reducing wage bill costs was considered to be fairer to staff than a reduction in hourly wage rates, and reducing the working week to 4 days provided employees with an opportunity to work an extra day on their family plots and thus substitute their foregone income with increased subsistence or cash crop production.

30. Chuuk, Kosrae, and Pohnpei were expected to eliminate all operating subsidies and transfers as a further measure to reduce the cost of government. Subsidies and transfers generally remained high or even increased during the PSRP but have fallen subsequently. However, a large part of these are US federal funds provided outside the framework of the Compact. Many of the programs are expected to end in 2004 or shortly thereafter. On the other hand, most governments continue to provide support to loss-making commercial enterprises.



## **2. Increased Domestic Revenue Generation**

31. An improved revenue-generation effort required reforms to the structure and/or administration of nationwide taxes (such as import duties), the taxes imposed by individual states (mainly sales taxes), and nontax revenues such as user charges. The major change was moving the valuation basis for import duties from free-on-board to cost, insurance, and freight. At the same time, the coverage of the tax was extended to government-owned enterprises (which had previously been exempt). Receipts from import duties (excluding fuel) were 69% higher in the 4-year period following the introduction of the change (FY1998–FY2001) than in the 4 years prior to the reform (FY1994–FY1997). This can be attributed almost entirely to the change in valuation basis and improved administration of collections as the volume of imports has grown only marginally each year over the whole period.

32. The policy matrix set individual targets for improved revenue collection by each state. All states met the tax revenue targets prescribed in the matrix by the end of the program period. Consolidated tax revenue was 27% higher on average in the 4-year period FY1998–FY2001 than in the previous 4 years (Appendix 4). Tax effort—as measured by tax revenue as a proportion of gross domestic product (GDP)—has improved in all states, albeit from a low base. The average tax effort pre-reform was 10% of GDP. By the end of the program period it was 12%. In Yap, the best performing state, tax effort has averaged 17% over the past 3 years. As the tax structure in Yap is essentially the same as in the other states, this provides some indication of the scope for improving tax collections elsewhere in the FSM.

33. Nontax revenues have shown a significant decline. Fishing access fees have declined from an average of over \$20 million per annum prior to 1996 to less than \$14 million per annum thereafter, largely as a result of factors outside the control of the government. Both the national and state governments have also been impacted adversely by a decline in dividend and interest income, reflecting the lower volume of investments as reserves were drawn down to fund burgeoning expenditures in the pre-reform period and the lower yields on international investments in more recent years. Consolidated nontax revenues (excluding fishing access fees) have been declining steadily from about \$14 million per annum to less than \$10 million over the past few years.

34. Most states have increased user charges, particularly charges for electricity and in some cases water, since the commencement of the reform program. Utility corporations were created in each state as part of the PSRP, mainly to manage electricity generation and distribution, although some also handle water and sewerage.

## **3. Restructuring Government Operations and Public Enterprises**

35. The restructuring component had two dimensions. First, the downsizing of the public sector was expected to be driven by strategic reviews to determine the nature, function, and structural arrangement for the remaining core. Second, the policy matrix required the state governments to identify government activities to be eliminated, privatized, or contracted out and, separately, to initiate a review of public enterprise staffing patterns, operating costs, service provision, subsidy receipts, and other revenues and to divest noncore government activities.

36. In most states, the implementation of the ERS was only weakly related to a strategic restructuring of government departmental operations. Generally, the retirees were volunteers. The National Government, which has a relatively top-heavy structure because it does not provide front-line education or health services, combined its downsizing exercise with a

significant restructuring, reducing the number of departments from 11 to 6. This made it possible to reduce the number of senior and administrative staff. There was also some rationalization of national-state functions.

37. In Kosrae, the government stipulated that staff in some key positions were not eligible for the scheme. In Yap, department directors, subject to the governor's confirmation, decided which positions should be abolished with the result that many retirements were mandatory there. In the case of Chuuk, where the major departments are established by provisions in the state's constitution, it was found that a constitutional amendment would be necessary before any significant restructuring could take place in the five core departments, and no such amendment was made. However, some restructuring that could have taken place without such an amendment did not happen either. Also, some of the downsizing in Chuuk included people no longer actually working but who remained on the payroll until their inclusion in the ERS. There was a significant restructuring of government departments in Kosrae in FY1995-FY1996 at the commencement of the downsizing, which involved the amalgamation of several departments, followed by some further minor changes in 1999. Similarly, there was some amalgamation of departments in Pohnpei but no elimination of functions. In Yap, there was no significant restructuring associated with the downsizing.

38. All governments took action to eliminate, contract out, and/or divest some government activities, but these changes were relatively minor. For example, Pohnpei and Yap contracted out some hospital services such as catering, janitorial, and security services.

39. All governments also carried out the required review of their public enterprises. However, these and other independent agencies were generally not touched by the downsizing exercise. All governments are involved in commercial operations such as banking, fisheries, utilities, transportation and shipping, and management of ports. These commercial operations have received substantial transfers over the years both by way of capital injections and operating subsidies. Some have also received guarantees for borrowing and the authority to make substantial write-offs. Their operations are not very transparent and little information about their operation is made public, although a subsequent TA gathered performance information and created a public enterprise database.<sup>13</sup> Some of these public enterprises are now defunct. Others require regular transfers of scarce public financial resources.<sup>14</sup>

#### **4. Mitigating the Social and Economic Impact of the Reforms**

40. There were four components to the mitigation of social and economic impacts: ERS separation payments,<sup>15</sup> counseling, skills training, and outplacement advice. For older retirees approaching the age of compulsory retirement, the payments were to compensate them for the loss of earnings entailed in leaving the workforce a little earlier than they might have planned. For younger retirees, the payment was seen as a capital injection into the new business they were expected to establish.<sup>16</sup>

<sup>13</sup> ADB. 1999. *Technical Assistance to the Federated States of Micronesia for Privatization of Public Enterprises and Corporate Governance Reforms*. Manila.

<sup>14</sup> It is expected that the elimination of mandated grants from US federal funds for energy, communications, and other areas will see the level of subsidies decrease after 2004.

<sup>15</sup> A total of 1,058 people participated in the ERS, out of which available records provide more detailed information on the backgrounds of 829. Of these, about 58% received lump sum payments of less than \$10,000; 28% received between \$10,000 and \$20,000, and 14% over \$20,000.

<sup>16</sup> The National Government initially required all retirees more than 2 years away from compulsory retirement to submit draft business plans for approval before they could receive their lump sum payments. After receiving legal advice that the shareholders of failed enterprises might be able to sue the government for approving unrealistic

41. In the event, the scheme appears to have worked more or less as intended for retirees who were about 2 years away from the age at which they became entitled to social security payments (about 20% of retirees). The ERS also appears to have broadly met the aspirations of the significantly younger age retirees, although not in the way intended. Many in the younger age group used the lump sum to finance their emigration to Guam or the US in search of wider opportunities for themselves and their families.<sup>17</sup> The profile of retirees is provided in Appendix 5.

42. There was a third and relatively numerous category of retirees who were still some years away from the age of retirement (and eligibility for social security) and who did not migrate. For this group, the scheme also did not work as intended, mainly because of limited business opportunities and the fact that other components of the ERS designed to assist them were not implemented effectively, namely: (i) counseling services to help retirees come to terms with their situation, clarify their options and, in particular, provide practical advice on the initial management of the lump sums; (ii) training;<sup>18</sup> and (iii) outplacement advice. For this group as a whole, the lump sum payments helped to maintain household consumption at a higher level than would otherwise have proved possible.

## **5. Fostering Development of the Private Sector**

43. To achieve the economic restructuring objective, the private sector needed to grow. To this end, the PSRP targeted four factors that, between them, were considered to hold the key to private sector development: (i) improving the legal and regulatory environment for investment, (ii) enhancing the availability of finance for business, (iii) fostering public infrastructure provision, and (iv) promoting human resource development (HRD) policies in support of employment in the private sector.

44. The investment laws and regulations in the FSM were reviewed with a view to improving the environment for both foreign and domestic investment. An investment promotion agency was established in 1997 with TA (footnote 2) to help attract additional foreign equity. It established a website to provide information to prospective investors (although the site appears to not have been updated subsequently). The aim was to emphasize investment facilitation rather than investment regulation. A revised foreign investment act was passed that came into effect on 1 January 1998. Complementary legislation was passed by the states. However, the original intent of achieving a transparent and open regime free from bureaucratic discretionary intervention has not been fully achieved, largely as a result of regulations that to some extent negate the intent of the legislation,<sup>19</sup> perhaps reflecting an ambivalent attitude to foreign investment on the part of some decision makers. There is no evidence that foreign investment has increased as a result of the revised legislation or other support provided.

45. It was considered that the availability of credit for businesses had been impeded by the inability to offer land as collateral for bank loans. To help address this, the passage of legislation

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business plans, the National Government (and subsequently the state governments) dropped this requirement and paid the lump sums without any preconditions.

<sup>17</sup> The average lump sums available to younger workers (about \$9,000) were not sufficient to capitalize a new business, but were enough to meet the costs of migration. Preliminary analysis of the 2000 census data is consistent with the conclusion that many retirees moved abroad.

<sup>18</sup> A contemporary United Nations Development Program-funded project, the Micronesian Entrepreneurial Development Centers, provided some training to retirees but this was inadequately linked to other support services.

<sup>19</sup> Foreign Investment Advisory Service. 1999. *National and State Foreign Investment Legislation Review*. Washington.

to allow for 50-year leases in Pohnpei state was a condition of the PSRP. The legislation was passed but it appears to have made little difference as yet to the use of land as collateral. Land information systems will be improved under the Private Sector Development Program (PSDP, footnote 11). Fostering loan guarantee entities was one of the loan conditions of the PSRP. Only Pohnpei has such a scheme but there is no longer any need for this service because no foreign-owned bank now operates in Pohnpei.<sup>20</sup> The entity responsible for the service is reported as trying to get into lending to provide a role for its 12 employees. The development of a public sector investment program and its use to ensure priority infrastructure projects were funded was another program condition aimed at promoting private sector development. Generally, the public sector investment program process has not been particularly effective. However, this is likely to change under Compact II with the inclusion of a more directed and closely controlled infrastructure fund.

46. The PSRP conditions included measures on HRD designed to reorient the education system away from employment in the public sector and more toward creating the skills required by private sector employers. Essentially, a much greater focus on technical and vocational education was envisaged. Some work is ongoing on new school curricula to increase the emphasis on such education, but the matrix conditions requiring increased support for adult education and training were paid little if any attention during the program period, or indeed subsequently.

## **C. Effectiveness of Technical Assistance**

### **1. TA 2294-FSM: Policy Advisory Team for Economic Management**

47. TA 2294 (footnote 2) had three principal objectives: (i) to assist the governments in formulating economic strategy and economic policies that would lead to growth, and in particular address the major structural problems faced by the FSM; (ii) help monitor policy implementation and provide feedback on the effects of the structural adjustment; and (iii) provide on-the-job training and to help organize formal training to enable the Government to continue policy analysis in the medium term without continued reliance on expatriate staff. Following completion of the PSRP, ADB funded two further TAs in support of economic policy and management.<sup>21</sup> The objectives and scope of TA 3024 (footnote 21) did not specifically address HRD although it was implicit in its focus on strengthening institutional capacity. TA 3783 (footnote 21) also had its objective as institutional capacity building but a priority was attached to training FSM economists.

48. Since 1995, about \$5.5 million in TA assistance (TA 2294, including the supplementary TA, provided \$2.4 million) has been provided to the FSM for economic policy advice and capacity building, of which ADB contributed \$4.3 million, with the US cofinancing the balance.<sup>22</sup> The combined assistance funded two resident advisers (three during the supplementary TA) and a number of short-term consultants. While ADB has made a large contribution to economic

<sup>20</sup> Because foreigners may not own land in the FSM, the loan guarantee scheme was designed to allow foreign-owned banks to indirectly use land as collateral.

<sup>21</sup> ADB. 1998. *Technical Assistance to the Federated States of Micronesia for Economic Policy Reform and Management*, Manila and ADB. 2001. *Technical Assistance to the Federated States of Micronesia for Economic Policy Reform and Capacity Building (Phase 1)*, Manila.

<sup>22</sup> These figures are substantially less than the approved TA amounts because expected US cofinancing did not fully materialize, forcing ADB to reallocate \$650,000 from TA 3024 to TA 2294 to cover a shortfall with a consequent reduction in scope of the former. At the same time, the amount of cofinancing expected for TA 3024 was reduced to \$333,000. The duration of the resident adviser input was reduced from 36 to 24 months and short-term TA was reduced, including a planned input in support on socioeconomic impact monitoring.

policy advice provision and capacity building in this area over a number of years, particularly in relation to the size of the country, this is not unique among PIDMCs.<sup>23</sup> What is different about ADB's role in the FSM was that it funded resident advisers, whereas such advisers were provided by bilateral funding agencies in other cases. The unique context of the FSM with five governments across four island states, the very low level of skills prior to reform and an absence of other development partners willing to play this role provided a strong rationale for ADB's funding of resident advisers.

49. Another noteworthy feature of the assistance is that the same consulting firm has provided the services throughout (largely providing the same core personnel), having been awarded three competitively bid contracts since 1995.<sup>24</sup> This continuity enabled a more seamless and coherent program of policy advice, the building of long-term relationships with key members of the executives and legislatures, and the potential for a consistent approach to the HRD task while entailing some risk of "political capture" and "self perpetuation" to the detriment of domestic capacity development (para. 52). In this case, recruitment of advisers through a firm does not appear to have added value commensurate with the considerable additional cost over and above the cost of hiring individuals.

50. The EMPAT TA substantially achieved its first two objectives. Some of its more notable—but by no means only—achievements include (i) helping to generate and maintain a commitment to reform in both the legislative and executive branches of five governments across several electoral cycles, including facilitation of two rounds of economic summits; (ii) preparation of reliable statistics on economic and fiscal performance—an absolute prerequisite for good policy formulation—where none existed before and the dissemination and general acceptance of these statistics as the basis for policy making; (iii) considerable success in negotiating the difficult path of providing objective policy analysis valued by the government while avoiding "political capture" (telling the government what it wants to hear); (iv) facilitation of the creation of the Economic Policy Implementation Council (EPIC) as the paramount economic policy deliberation institution in the FSM; and (v) a very significant contribution to the successful negotiation of Compact II funding. The impact of the microeconomic policy advice provided by EMPAT consultants was twofold. First, it contributed to the formulation of a private sector development strategy, which led to the preparation of the PSDP. Second, it helped reduce (although not eliminate) further government investment in nonviable commercial activities.

51. The EMPAT TA also had significant achievements on its third objective of HRD—both directly with four young masters-level economists trained and more widely in terms of greatly expanded awareness of policy issues and the value of policy analysis in the executive and legislative branches, and in the community. Initially, the TA started to work with nominated counterparts. It soon became evident that this approach would not produce a domestic capability to provide high-quality economic policy advice. Consequently, an alternative was adopted whereby young and enthusiastic graduates worked full time in the EMPAT team for around 18 months to assess their aptitude and interest. Based on this assessment, they were

<sup>23</sup> On a per capita basis, ADB's support to the FSM for economic policy advice and capacity building is \$40 to date. Comparative figures for other PIDMCs are: \$88 to the Cook Islands; \$45 to the Republic of Marshall Islands (RMI); \$20 to Kiribati; \$18 to Samoa; and, \$13 to Vanuatu. In the FSM and RMI, the US provided cofinancing equal to around 20% of ADB's contribution. In the other PIDMCs, apart from RMI, other funders (notably Australia and New Zealand) provided substantial related assistance. Although figures are not available, it is estimated that this was generally many times more than the amount provided by ADB and the US to FSM and RMI. Also, these sources usually funded resident advisers, a role filled by ADB in the FSM.

<sup>24</sup> Again, this is not a unique situation. One firm provided the same personnel in Samoa across a number of contracts over a similar period. This firm also provided the same personnel to support economic policy in Kiribati.

sent abroad for postgraduate training. On return, they were incorporated into an expanded EMPAT team and given increasing responsibilities. The quality of the economists trained by this method is very high. Developing a capacity to provide macroeconomic policy advice is not just a matter of providing postgraduate training or short-term on-the-job training. Experience elsewhere in the Pacific has shown that attempts at “quick fixes” by giving academically-qualified people responsibilities for which they are manifestly unprepared in terms of job experience is counter-productive as it actually delays the achievement of self-sufficiency. Also, experience shows that the more typical noncontinuous TA may achieve very little in terms of increased competence and performance even though it may produce tangible outputs and help establish systems and processes. Rather, people with the right qualifications and dedicated to the task need to learn on the job by gradually assuming greater responsibilities under the guidance of skilled professionals.

52. Three concerns may arise where advisers are present over an extended period. First, they may tend to fill a line role rather than an advisory role. Second, they may “crowd out” the local staff, in addition to the “political capture” mentioned in para. 50. Where no or few skills exist in an area such as economic policy advice it is inevitable and desirable that the TA consultants carry out the analysis of data and prepare policy papers—indeed, this was one of the objectives of the TA. As domestic capacity develops, the role of the advisers changes from a more hands on to a more hands-off role. This progression has been evident in EMPAT. There is no evidence that the foreign advisers have crowded out the domestic staff in EMPAT. Rather, the role of the EMPAT team has expanded, particularly as a result of the one-off need for analytical work in support of Compact II negotiations. In this, and other areas, the lead has increasingly been taken by the domestic staff.

53. TA 2294 (EMPAT I, footnote 6) as a whole (and taking into account the EMPAT TAs that followed) is rated as successful.<sup>25</sup> It is assessed as relevant and highly efficacious. Its relevance was marked down somewhat because the HRD objective was overambitious. It is assessed as efficient with likely sustainability of the policy advice provided. While the number of trained economists is not large, the achievements compare more than favorably with those of other PIDMCs. Two of the four economists have moved back to their states of origin, thus providing a useful dispersal of skills. While the FSM is not yet self-sufficient in high-level economic policy advice, statistical analysis, or fiscal monitoring, it has made considerable progress in this direction. More is needed. There were significant other impacts, particularly in terms of awareness creation on the value of economic policy and the need for reform.

## **2. TA 2786-FSM: Investment Promotion and Financial Sector Review**

54. TA 2786 (Investment Promotion and Financial Sector Review, footnote 2) is rated as partly successful as it was less efficacious with sustainability unlikely and there were only moderate other impacts. In particular, TA 2786 provided recommendations that in some cases were not consistent with the principles underpinning the PSRP—i.e., less government. For example, it promoted an expanded small business development center network and creation of state-level government entities to provide loan guarantees. A foreign investment promotion unit was created along with a website. There is no evidence of increased foreign investment as a result of the TA, although to be fair, uncertainty regarding Compact II may have contributed to a negative investor sentiment toward the FSM.

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<sup>25</sup> Based on a four-category rating scale of highly successful, successful, partly successful, or unsuccessful.

### 3. Related Technical Assistance

55. There was a considerable amount of related TA during and after the PSRP period.<sup>26</sup> Most notable among the related TAs is a group of four TAs for a total of \$2.2 million in support of performance-based budgeting and financial management. Although beyond the scope of this PPAR, it would be interesting to compare the HRD achievements of these TAs to those of EMPAT. TA 3258, which aimed to strengthen the national statistical system, would also provide an interesting comparison.

#### D. Compliance with Covenants

56. The Government generally complied with the loan covenants. Areas of deficiency were the lack of regular quarterly reporting and timely preparation of a completion report and lack of complete implementation of the policy matrix as detailed in this report.

## III. PROGRAM OUTCOMES

### A. Achievement of Purpose

57. The goal of the PSRP was the transformation and development of a more efficient FSM economy. The primary purpose of the reforms was to stabilize the economy in the face of significantly reduced external assistance.

58. From 1987 to 1995, the economy grew strongly at an average annual rate of 4.3%, supported by the large external transfers, with the private sector growing by 7.1%. However, the strong private sector activity did not reflect growth in the traded goods sectors or the emergence of significant export activities. Rather, it represented the emergence of a modern cash economy as nontraded goods production expanded to meet growing demand and resources were attracted out of the subsistence sector.

59. Because Compact base grants were only partly indexed to US inflation, there was an average annual decline of 4% per annum in the real value of the resource flows. The two step-downs further reduced real flows. The first step-down, with effect in FY1992, created relatively few adjustment problems and there was little impact on the GDP growth rate. Current budget expenditure as a proportion of GDP was still broadly in line with the level of grants as a proportion of GDP (and much less than the level of total revenues and grants as a proportion of GDP) and the current fiscal deficit was no more than 1% of GDP.

60. The second step-down was larger and required a more significant adjustment on the part of the five governments. With the assistance of the PSRP loan, all governments were able to reduce staff numbers and the cost of the wage bill so as to reduce total expenditure and net

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<sup>26</sup> These include: (i) ADB. 1997. *Technical Assistance to the Federated States of Micronesia for Improved Economic Use of Land*, Manila; (ii) ADB. 1997. *Technical Assistance to the Federated States of Micronesia for Fisheries Management and Development*, Manila; (iii) ADB. 1998. *Technical Assistance to the Federated States of Micronesia for Performance-Based Public Resource Management*, Manila; (iv) ADB. 2000. *Technical Assistance to the Federated States of Micronesia for Improving Capacity in Performance-Based Public Finance Management Implementation*, Manila; (v) ADB. 2001. *Technical Assistance to the Federated States of Micronesia for Implementation of Performance-Based Budget Management*, Manila; (vi) ADB. 2002. *Technical Assistance to the Federated States of Micronesia for Capacity Building in Public Sector Financial Management*, Manila; (vii) ADB. 1999. *Technical Assistance to the Federated States of Micronesia for Privatization of Public Enterprises and Corporate Governance Reforms*, Manila; and (viii) ADB. 1999. *Technical Assistance to the Federated States of Micronesia for Strengthening the National Statistical System*, Manila.

lending to a level that ensured a small positive fiscal balance of \$1.7 million on the current account for the FSM as a whole by the end of FY1998. The improvement in tax effort also contributed to this outcome. The four state governments managed to achieve positive balances on their current accounts by the end of FY1998. Only the National Government recorded a deficit (of \$10.7 million), mainly reflecting its inability to adjust quickly to the large unexpected drop in fishing access fees and its reduced share of national revenues under a new revenue-sharing formula.<sup>27</sup> The balance of payments current account in FY1998 recorded a deficit of \$11.9 million (5.8% of GDP)—not much larger than the second tranche drawdown of \$8 million during that year.

61. Real GDP declined by 3.2% in 1996 and by 4.5% in 1997 as the economy was impacted adversely first by the financial crisis in Chuuk and then by the wage bill reductions. However, by 1998 the rate of economic contraction slowed to 2.9% and in the following year the economy returned to positive growth, albeit only 0.2%. By 2000, the economy was growing strongly at over 6%. Even though the authorities did not reach the personnel and wage bill reduction targets set out in the policy matrix, it is clear that from a stabilization perspective, the PSRP was very successful in restoring fiscal balance by the end of FY1998 and securing a return to positive economic growth by FY1999, thus avoiding a potentially very destabilizing financial situation.

62. The second purpose of the reform package was to commence the restructuring required to foster the private sector as the new engine of growth in the FSM. A useful start has been made in several major areas. The two most important things the government has done to create an environment more favorable to the private sector have been to restore macroeconomic stability and finalize the negotiations with the US on Compact II. Both of these steps have removed major areas of uncertainty for investors and thus reduced private sector business risk. However, there has been little change in public and private sector share of economic activity (Table 3).

**Table 3: Public and Private Share of Gross Domestic Product**  
(%)

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 est.	FY02 est.	FY03 proj.
Government Share of Gross Domestic Product	37	38	39	38	35	34	33	34	35	34
Private Sector Share of Gross Domestic Product	33	32	31	29	30	30	32	32	31	32

est = estimate, FY = fiscal year, proj = projection.

Source: Economic Policy Management and Advisory Team. Available at [www.empat.fm](http://www.empat.fm).

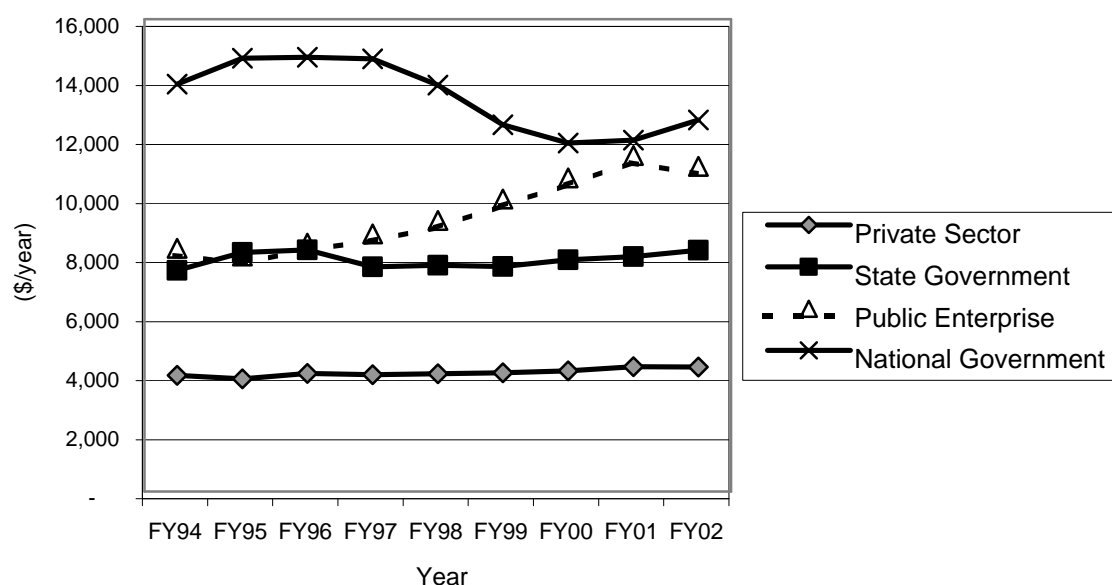
63. The next most important action required to promote economic restructuring is to reduce the gap between public service and private sector wage rates in order to encourage a shift of resources from the public to the private sector. There has been some narrowing of the gap in average wage rates between private sector and National Government wages but no change

<sup>27</sup> Instead of allocating 50% of taxes (and 80% of the fuel import tax) to the states, it was decided to allocate 70% to the states and only 30% to the National Government (although the additional 20% allocated to the states can only be spent on health and education projects).



against state government wage rates while the gap has widened between the private sector and public enterprise rates (Figure 3). The rapid increase in wage rates in public enterprises can be partly explained by the creation of utility corporations, which accorded their staff significant wage increases. As of FY2002, the average wage rates in the government sector ranged between 1.9 and 3.0 times those in the private sector. However, these average figures overstate the differential between public and private sector wages in some cases as the two sectors have different worker profiles in terms of skills and qualifications. A comparison of public and private wage rates for particular skills shows that public rates exceed those in the private sector by 29% for accountants, 48% for teachers, and 53% for security guards.<sup>28</sup>

**Figure 3: Average Wages in the Private and Government Sectors**



Source: Economic Policy Management and Advisory Team. Available at: [www.empat.fm](http://www.empat.fm).

## B. Sustainability

64. The sustainability of the reforms has been put in some doubt by a resurgence of expenditure (Figure 2), especially in Chuuk, and the appearance of a structural deficit in the accounts of the National Government. Chuuk made the largest fiscal adjustment in FY1997, reducing current expenditures to just \$26 million from a peak of \$54 million in FY1991. However, as soon as it had repaid its debts the state government reverted to its previous pattern of behavior.

65. Kosrae has also had a resurgence in expenditure, mainly due to wage costs. A large part of the reduction in wage and salary costs in Kosrae was achieved by reducing working hours. These cuts have now been reversed using the “bump-up” funds to restore working hours (footnote 5). Although Kosrae has maintained a positive fiscal balance up to this point, it will not be able to do so after FY2003, under the reduced level of base funding applicable from next year, unless it makes further reductions in the wage and salary bill—either by additional redundancies or by again reducing working hours. The state’s leadership is aware of the

<sup>28</sup> Department of Statistics Chuuk State, unpublished data.

problem and has expressed its determination to do whatever may be necessary to avoid incurring a deficit.

66. The National Government's fiscal problems are, in some ways, more serious than those of the states. It faces a serious structural deficit stemming largely from a deterioration in its revenues but also attributable to poor expenditure policies. The National Government has not responded sufficiently strongly on the expenditure side to the permanent loss of about \$12 million in revenue. It has financed its deficit by drawing down reserves, but they are now exhausted. Adjustment will require a deep cut in National Government expenditures or major new revenue measures or a combination of the two.

67. The longer-term sustainability of the public sector reforms hinges upon the willingness of the national and state leadership to adhere to firm financial disciplines. The FSM needs a medium-term financial framework of the kind that many other governments around the world use to set limits to the expansion of public expenditures and to ensure that the evolution of the fiscal aggregates, including taxation, are consistent with other macroeconomic goals and settings, such as the savings rate and maintaining balance of payments equilibrium. It may not be necessary to construct such a framework anew in the FSM. To a large extent, the financial arrangements of Compact II already provide a structure that bears many similarities to a medium-term financial framework. The Compact II provisions are clearly intended to ensure that the government continues to contribute to national savings and that government investments are much more productive than they have been in the past. A positive rate of saving and productive investments should go a long way toward ensuring that the country avoids any balance of payments problems. These arrangements will lock into place the achievements of the PSRP.

68. A final factor that can influence sustainability is the profile and burden of debt. The FSM has adopted a prudent debt management strategy in recent years. Since it repaid the medium-term notes issued in the early 1990s, the only external debt incurred has been from ADB on concessional terms. The debt to GDP ratio stands at 23% and the debt service ratio in 2002 was 7.5% of exports of goods and services. These are very low levels. Moreover, the true burden of the servicing ratio is greatly overstated given that the FSM holds a sinking fund equal in value to the amount outstanding to ADB for the PSRP loan. There is nothing in the FSM's debt position to threaten the sustainability of the reforms.

### **C. Socioeconomic Impact**

69. A substantial public sector downsizing in an economy dominated by the public sector had the obvious potential to have a significant socioeconomic impact. This was acknowledged in the design through incorporation specific mitigation measures (para. 40). Early retirees adopted two main coping mechanisms: (i) increased participation in semi-subsistence activity of farming and fishing with some sale of surplus production; and (ii) emigration, which is facilitated by the Compact's liberal migration provisions. For various reasons, including a lack of transition support services (para. 41), not all ERS payments were used for productive investments. Anecdotal evidence shows that a number of retirees used their retirement payment to purchase vehicles and renovate houses.<sup>29</sup>

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<sup>29</sup> Vehicle registration data that shows an increase in the number of private vehicles, which rose from 1,931 units in 1994 to 3,475 in 1998.

70. The socioeconomic impact of the PSRP was assessed by comparing selected indicators for the pre- (1994) and post- (2000) program periods (Appendix 6). This shows that the substantial downsizing of the public sector produced changes in the country's demography, pattern of economic activity, and the quality of social services. Emigration has increased by more than 100%, from about 11,000 in 1994 to about 26,000 in 2000. However, the outward migration has had a positive impact on the economy as remittances more than compensated for the decline in domestically generated income.

71. The employment rate dropped from 84% in 1994 to 78% in 2000. The decline was mainly due to the contraction of the formal sector largely dominated by the public sector. The share of formal work force to total employment decreased significantly from 66% in 1994 to 48% in 2000. On the other hand, the lack of opportunities in the formal sector resulted in an increase in subsistence activities.<sup>30</sup> The share of total subsistence workers increased from 34% in 1994 to 52% in 2000. Both the increased emigration and increase in subsistence activities have helped alleviate the adverse impact of downsizing in the public sector.

72. The changes in economic activity have led to changes in income levels. The median income dropped to \$1,489 in 2000 compared with \$2,637 in 1994. Likewise, the number of persons receiving income below \$1,000 went up significantly from 6,426 in 1994 to 15,083 in 2000. The relative importance of various sources of income has changed. In 2000, 40% of individuals derived their income from remittances, while 33% did so from wages and salaries. This was a significant change from the 1994 census, when wages and salaries accounted for 59% of those who reported receiving income in 1994. The share of profits from small businesses and farming as source of income increased to 16% in 2000 from 8% in 1994. There was an increase in the number of people who reported having income, but much of the increase appears to have come from increased remittances.

73. There appears to have been some negative impact from the reforms on service quality in education (but not health). At the elementary level, results of the National Standardized Test in language and mathematics indicate a declining trend during the period 1997 to 2000.<sup>31</sup> Negative impacts are also discernable at the secondary level.<sup>32</sup> The PSRP also had some negative gender impacts. The increase in women's role in subsistence production and the predominance of women in private sector employment is largely in unpaid or low-wage work. Subsistence production tends to be a low-status activity, with the exception of some villages on Yap. The share of female workers (to total female employment) increased from 52% in 1994 to 57% in 2000. However, the median income for female workers decreased by more than half, from \$1,910 in 1994 to \$918 in 2000, due the growing concentration of females in low-income occupations.

<sup>30</sup> The number of pure subsistence workers increased almost 100% from 5,874 in 1994 to 10,624 in 2000, thus the share to total employment rose from 27% in 1994 to 36% in 2000. Also, the number of persons engaged in market-oriented subsistence activities increased from 1,501 to 4,592, with the share going up to 16% in 2000, from 7% in 1994.

<sup>31</sup> A standardized testing program in language and mathematics for grades six, eight, and ten conducted by the National Department of Education to evaluate the effectiveness of the FSM's National Curriculum Minimum Standards.

<sup>32</sup> Based on the annual entrance test administered by the College of Micronesia, there has always been significant difference in passing rates between students of public and private schools but the disparity was wider during the program period.

## **D. Environmental Impact**

74. There has been no discernable adverse environmental impact from the PSRP. Environmental protection agencies remain active as part of government structures.

## **IV. OVERALL ASSESSMENT**

75. The PSRP is assessed as highly relevant. Its relevance was very high in terms of its fit with ADB strategy at approval and now. It had a good fit with stated strategy at the country level but it is now clear that not all decision makers accepted the pessimistic assumptions of greatly reduced funding after 2001. The PSRP was somewhat less relevant in terms of the sufficiency of policy measures for achievement of the purpose of shifting the balance of economic activity from public to private sector. However, it is envisaged that the PSDP (footnote 11) will go some way to addressing this shortcoming.

76. The PSRP is assessed as efficacious. This rating is dependent on the weighting given to the component for fiscal restructuring. It was highly efficacious in this area but somewhat less so for the other four components.

77. The PSRP is assessed as efficient. The use of counterpart funds was highly efficient with those not required for the ERS quarantined for debt repayment. Three of the five governments met the conditions for release of the second tranche in a timely fashion. Ideally, ADB could have provided more support as implementation proceeded, particularly at the state level and to the work of the EMPAT team. Support from key agencies at the national and state levels was generally good but some pro-reform legislators lost office to those who campaigned against the reform. This induced a degree of “reform fatigue.”

78. The sustainability of the PSRP is assessed as likely. The National Government and those of Pohnpei and Yap states have sustained the reductions in public service staff numbers and costs. However, there has been some reversal in Kosrae and Chuuk states, made possible by the provision of the “bump-up” funds. The gains made in increased revenue generation are sustainable. In the other areas, progress was limited and the chance of further gains is assessed as less likely. Nevertheless, the Compact II is likely to force a new political reality on those governments that have been reluctant to take some hard decisions. Therefore, the reversals observed are likely to be temporary. The PSDP also contains conditionalities that support the sustainability of reforms from the PSRP.

79. In terms of institutional development and other impacts, the PSRP is assessed as having had significant impacts. On the positive side, there have been substantial gains in institutional capacity (in both the executive and legislative branches) and in general awareness and involvement of the community. On the negative side, there have been some adverse impacts on gender, income and service quality. However, without the PSRP's reforms and the contribution of EMPAT to a successful Compact II negotiation, these negative impacts could have been much more severe.

80. The overall rating for the PSRP is successful.

81. The performance of ADB was highly satisfactory initially as there was a strong commitment to maintaining direct dialogue with the states as well as the National Government. Gradually, and up to the present time, there has been some reduction in staff support to the reform process. Systemic problems such as unavoidable changes in project officers and

pressure of other work have contributed to this reality. Overall, the performance of ADB is rated as satisfactory.

82. Up to the end of the program period, the performance of the national, Kosrae, and Yap governments was highly satisfactory while that of Chuuk and Pohnpei governments was satisfactory. Subsequently, the performance of Chuuk and Kosrae governments has been less than satisfactory. Overall, the performance of the governments is rated as satisfactory.

## **V. CONCLUSIONS**

### **A. Lessons**

#### **1. Lessons on Public Sector Reform**

83. A number of lessons can be learned from the implementation of the PSRP. First, it is not desirable to design a major public sector downsizing based on voluntary redundancies. In order to maintain an acceptable standard and quality of service delivery, managers should ensure that they retain the key staff they need to maintain the core competencies of their organizations. Ultimately, managers should control who is, and who is not, eligible for an ERS. On the other hand, the voluntary nature of the program enhanced its political feasibility.

84. Second, the provision of transition services to public servants made redundant cannot be left to existing institutions because they are simply not equipped to handle that sort of work. This task requires a specialized, albeit temporary, agency with appropriately qualified staff and adequate resources to provide the range of counseling, outplacement advice, and retraining services required. Furthermore, the chances of out-placed public servants becoming successful entrepreneurs can be strongly influenced by the nature of the business environment within which they are expected to work. The private sector has a better chance of developing in the absence of discretionary regulations and government interventions, and unequal competition from government businesses that receive subsidies, do not pay taxes, and do not pay for the cost of their borrowing or capital by paying interest or dividends to the government.

85. Another set of lessons relates to the manner in which the reform program was designed and implemented. First, the time-consuming efforts at consensus building prior to the reforms being implemented provided the essential foundations for the broad adoption of the reforms and contributed to their ultimate success. Second, the economic policy analysis and advice that informed the debates at the subsequent national and state summit meetings and the EPIC meetings were also important to success. A further lesson follows directly from the two previous conclusions—the process of reform and structural adjustment in the FSM will necessarily take a long time and requires a core of champions capable of understanding the rationale for the reforms and who can maintain a clear strategic direction. The considerable effort invested in building the policy capabilities of a core group of officials is already paying dividends but needs to be maintained.

86. The less successful projected outcomes of the PSRP were not predicted because there was insufficient social analysis of historical, structural, socioeconomic, and cultural conditions during preparation. Such analysis would have taken greater account of the 30 years of welfare-driven public policies. A deeper analysis might have suggested less optimistic predictions concerning private sector growth and indicated the more likely outcome of increased emigration. This consideration may have directed attention to the importance of education and HRD as a mitigating strategy.

87. The effort to reform and divest public enterprises has not been as successful as hoped. One reason is that in such a small, low-income country with a weak private sector, there are few people with the capital and/or business experience to bid for or successfully manage such enterprises. The lesson is that public enterprise reform requires a more creative approach to involving the private sector in the management of public assets, e.g., through greater resort to facilities management contracts to help provide a more gradual pathway to the accumulation of both experience and capital.

## **2. Lessons for ADB**

88. There are important lessons regarding the nature of TA for HRD in the Pacific and elsewhere, particularly where skills are initially low or nonexistent. The EMPAT TA has produced concrete results in HRD but it has taken time. Conversely, other evaluation experience has shown that the more typical “counterpart” approach has “failed to establish sustainable local capabilities for economic management” notwithstanding considerable provision of TA.<sup>33</sup> ADB may decide that such a significant allocation of resources to this type of HRD is not the best use of its TA resources. However, if so, it is important that it does not set unrealistic objectives for capacity-building TAs that involve significant HRD from a low base.

89. A further lesson for ADB relates to the political economy of reform programs. Restructuring an economy calls for short-term sacrifice for long-term gain. This is inherently difficult to manage within a 3- or 4-year election cycle. Nonetheless, program design should take more account of the practical consequences of this for politicians (and for their appetite for reform) by endeavoring, wherever possible, to ensure some early positive results, which will both reward the champions of reform and strengthen their ability to pursue further reform.

## **B. Key Issues for the Future**

90. The restructuring efforts to date have had little impact on relative prices. In the absence of an exchange rate (the country uses the US dollar as its currency), the FSM government must look at other price levers to induce the resource shift it needs. The wage rate is the key parameter. The generous resource flows under Compact I allowed successive governments to outbid the private sector for labor. This trend must be reversed by narrowing the differential between public sector and private sector wage rates.

91. The downsizing achieved to date lacked a strategic dimension—insufficient attention was given to streamlining the machinery of government and refocusing government activities upon the role and functions that only governments can perform in delivering public goods. The national and state governments need to be much more proactive in eliminating functions they do not strictly need to perform and, in particular, in liquidating or divesting themselves of commercial enterprises. The medium-term aim should be to reduce the public sector to a level that can be financed by a reformed tax structure delivering about 20% of GDP in tax revenue and the level of external resource flows from all sources (including the Compact Trust Fund) likely to be available to the FSM at the end of Compact II. This implies a public sector of a size probably equivalent to about 25–30% of GDP, compared to the current level of around 35%.

92. The revenue effort in the FSM at present is inadequate. The current tax structure is not capable of delivering the level of revenue the country needs. A broad-based consumption tax is

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<sup>33</sup> ADB. 2002. *Program Performance Audit Report on the Economic Restructuring Program in the Cook Islands*. Manila.

an essential component of a reformed tax structure for two reasons: it is the only tax capable of providing a significant increase in the tax yield without distorting economic incentives, and because it is a largely self-policing tax system where the interests of individual taxpayers work to enforce compliance by all. Other PIDMCs have introduced the tax (e.g., Samoa, Cook Islands, and Vanuatu) so there should be little question about the ability of the country to introduce and manage such a tax. However, its introduction does require a considerable initial effort—in taxpayer education and training, as well as in training tax office staff. It will require external assistance through the early years of implementation. It is not worth undertaking all this effort unless the tax is set at a level that justifies the investment—for example, 12.5%.

93. Attempts to liberalize the investment laws have been undermined by the introduction of regulations that provide politicians and officials with considerable discretion in approving, rejecting, or amending foreign investment proposals. The country would be better served by an investment regime that adopted a transparent legal and regulatory framework and then permits companies meeting the criteria to operate as of right.

94. The various restrictions imposed upon the public service in order to reduce wage and salary costs has impacted adversely on public service morale. Staff assessments are no longer carried out, allegedly because there is no longer any point to the exercise. There are no incentives to encourage staff to perform to high standards or to excel. In the long run, this is an untenable situation. On the other hand, it would be unwise to simply lift all the restrictions without a clear strategy for handling the pent-up demand for higher wages, which in any case need to be brought in line with rates prevailing in the private sector.

95. Declining US budgetary support to the FSM may only result ultimately in a shift of costs from aid budgets to welfare budgets. Poorly educated, including unemployable, people in the FSM are exercising their option to move to the US and its territories. Accordingly, the state and federal governments should be encouraged to consider how their development policies can optimize the benefits of current migration trends. Trends over the past decade indicate that the FSM is likely to develop an economy in which migration and remittances become significant forces in maintaining low population growth and reasonable levels of social welfare.<sup>34</sup> HRD is an investment that will pay dividends by enabling migrants to be accepted and obtain employment abroad.

96. The recently concluded Compact II negotiations provide a window of opportunity to lock in and ensure the sustainability of the PSRP. But adapting to the new arrangements and learning to live with the new disciplines imposed by the Compact rules will likely require further assistance.

### **C. Follow-Up Actions**

97. Follow-up actions for the governments are summarized in Table 4.

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<sup>34</sup> Some Pacific Island nations, such as Samoa, perceive migration and remittances as a highly positive solution to the country's limited prospects for economic development. Accordingly, the Government of Samoa has adopted a policy of improving all domestic services that raise living standards, and the quality and standards of education that, among other benefits, enable migrants to be more successful abroad.

**Table 4: Summary of Follow-Up Actions**

<b>Action</b>	<b>Responsibility</b>	<b>Timeframe</b>
The provisions of Compact II provide an opportunity to further the gains made by the Public Sector Reform Program. The imminent return of a fourth postgraduate economist and recent approval to recruit two more staff for training as economists provide the rationale for further technical assistance in support of economic policy capacity development.	Department of Economic Affairs (DEA), Department of Finance and Administration (DFA), and counterparts in the state governments  Pacific Regional Department	2 months
As part of the discussion above, the Federated States of Micronesia should prepare a road-map to self sufficiency in the provision of economic policy advice with clear targets and indicators.	DEA, DFA, and counterparts in the state governments	2 months
Taking advantage of the changes required by the advent of Compact II, the governments should initiate a strategic review of government functions and initiate a restructuring that provides a much clear focus on core activities and an overall size of government of around 25% to 30% of gross domestic product.	DEA, DFA, and counterparts in the state governments	Review – 6 months Implementation – 6 to 24 months
The governments should develop a plan for bringing public and private wages for similar skills into alignment with each other.	DEA, DFA, and counterparts in the state governments	12 months
The governments should introduce a broad-based consumption tax, set at a level to justify its introduction (for example, 12.5%) with the aim of achieving a tax take of around 20% of gross domestic product.	DFA counterparts in the state governments	12 to 24 months
The governments should prepare a policy paper for contract management by the private sector of natural monopolies as an alternative to privatization.	DEA, DFA, and counterparts in the state governments	12 months



## POLICY AND INSTITUTIONAL REFORM MATRIX

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>A. Reduce Size and Operating Costs of Civil Service</b>			
<b>1. Public Service Downsizing</b>			
<b>National Government, Chuuk, Pohnpei, Kosrae, Yap</b>			
<ul style="list-style-type: none"> <li>Establish task forces on government restructuring to determine realistic and sustainable staffing needs.</li> </ul>	April 1997	} Completed.	Reports of the task forces not sighted but reportedly prepared apart from Kosrae. Limited implementation of reports.
<ul style="list-style-type: none"> <li>Complete report of the task force on government restructuring with fixed targets for realistic and sustainable staffing needs.</li> </ul>	March 1998		
<b>National Government</b>			
<ul style="list-style-type: none"> <li>As part of the fiscal year (FY)1997 budget process, set operating expenditure reduction targets of 10% annually and personnel reduction targets of 5% in FY1997 and 20% in FY1998.</li> <li>Reduce operating expenditures by 10% from FY1997 level and reduce personnel by 5% from the FY1996 level.</li> <li>Reduce FY1999 operating expenditures by 10% from FY1998 and personnel by 20% from the FY1996 level.</li> </ul>	April 1997	} Incomplete.	Progress made but targets not fully met.
<b>Chuuk</b>			
<ul style="list-style-type: none"> <li>Set personnel reduction targets as part of the FY1997 budget process:               <ul style="list-style-type: none"> <li>(i) 11% reduction by 31 December 1996,</li> <li>(ii) 21% reduction by 31 May 1997, and</li> <li>(iii) 29% reduction by 31 May 1998.</li> </ul> </li> <li>Reduce personnel in public service by 21% from the FY1996 level.</li> <li>Reduce personnel in public service by 29% from the FY1996 level.</li> </ul>	April 1997	} Nearly completed; second tranche condition met; 26% reduction by November 1999.	Progress made but targets not fully met. Some reversal after the end of the program period.
	March 1998		
	December 1999		
<b>Kosrae</b>			
<ul style="list-style-type: none"> <li>Set personnel reduction target as part of the FY1997 budget process and reduce by 13% by mid-1997.</li> </ul>	April 1997	} Completed; 18% reduction to date.	Target exceeded.
<ul style="list-style-type: none"> <li>Reduce personnel in public service by 13% from the FY1996 level.</li> </ul>	March 1998		

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>Pohnpei</b> <ul style="list-style-type: none"><li>Set personnel reduction targets as part of the FY1997 budget process:<ul style="list-style-type: none"><li>(i) 10% reduction by mid-1997,</li><li>(ii) 20% reduction by mid-1998, and</li><li>(iii) 25% reduction by mid-1999.</li></ul></li><li>Reduce personnel in public service by 10% from the FY1996 level.</li><li>Reduce personnel in public service by 25% from the FY1996 level.</li></ul>	April 1997  March 1998  December 1999	Nearly completed; second tranche condition met; 21% reduction to date; Economic Reform Program continuing, intending to establish fiscal targets.	Progress made but target not fully met.
<b>Yap</b> <ul style="list-style-type: none"><li>Set personnel reduction targets as part of the FY1997 budget process:<ul style="list-style-type: none"><li>(i) 17% reduction by mid-1997,</li><li>(ii) 25% reduction by mid-1998, and</li><li>(iii) 28% reduction by mid-1999.</li></ul></li><li>Reduce personnel in public service by 17% from the FY1995 level. Review adequacy of 28% force reduction.</li><li>Reduce personnel in public service by 25% from the FY1995 level. Review adequacy of 28% force reduction.</li></ul>	April 1997  March 1998  December 1999	Completed.	Target exceeded.
<b>National Government</b> <ul style="list-style-type: none"><li>Implement hiring freeze for public service positions and ensure it is reflected in the FY1997 approved budget.</li><li>Maintain hiring freeze for public service.</li><li>Maintain hiring freeze for public service.</li></ul>	April 1997  March 1998 December 1999	Completed.	Undertaken and maintained.
<b>Chuuk</b> <ul style="list-style-type: none"><li>Implement hiring freeze for public service positions and ensure it is reflected in the FY1997 approved budget.</li><li>Maintain hiring freeze.</li><li>Maintain hiring freeze for public service, but with review by task force.</li></ul>	April 1997  March 1998 December 1999	Completed.	Undertaken but not maintained.
<b>Kosrae</b> <ul style="list-style-type: none"><li>Institute a rigorous assessment process for hiring, promotions, and reclassifications.</li><li>Maintain a rigorous assessment process for hiring, promotions, and reclassifications.</li><li>Maintain a rigorous assessment process for hiring, promotions, and reclassifications.</li></ul>	April 1997  March 1998  December 1999	Completed; hiring and promotion freeze in place.	Undertaken and largely maintained.

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>Pohnpei</b> <ul style="list-style-type: none"> <li>Implement hiring freeze for public service positions, and ensure it is reflected in the FY1997 approved budget.</li> <li>Maintain hiring freeze for public service, but with review by a subcommittee of Economic Planning Commission for any essential/emergency hiring.</li> <li>Maintain hiring freeze for public service, but with review by a subcommittee of Economic Planning Commission for any essential /emergency hiring.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Undertaken and maintained.
<b>Yap</b> <ul style="list-style-type: none"> <li>Freeze promotions, reclassifications, and merit allocations.</li> <li>Ensure the approved budget reflects the freeze on promotions, reclassifications, and merits.</li> <li>Ensure the approved budget reflects the freeze on promotions, reclassifications, and merits.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Undertaken and maintained.
<b>2. Wage/Salary Reduction</b>			
<b>National Government, Chuuk, Pohnpei, Yap</b> <ul style="list-style-type: none"> <li>Freeze automatic step increases.</li> <li>Maintain freeze on automatic step increases.</li> <li>Maintain freeze on automatic step increases.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Undertaken in all states but not maintained in Chuuk.
<b>Kosrae</b> <ul style="list-style-type: none"> <li>Revise step increases from annual to biennial.</li> <li>Ensure the approved budget reflects the delay in step increases, as reflected in the FY1998 budget.</li> <li>Ensure the approved budget reflects the delay in step increases, as reflected in the FY1999 budget.</li> </ul>	April 1997 March 1998 December 1999	Completed. Other adjustments sufficient.	Undertaken.
<b>Kosrae</b> <ul style="list-style-type: none"> <li>Implement on across-the-board wage cut of 12.5% for all government employees.</li> <li>Ensure the approved budget reflects wages cut.</li> <li>Ensure the approved budget reflects wages cut.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Undertaken by way of reducing the working week but wage and salary reduction almost completely reversed.
<b>National Government</b> <ul style="list-style-type: none"> <li>Restrict leave accrual.</li> <li>Ensure the approved budget reflects reduced leave accrual.</li> <li>Ensure the approved budget reflects reduced leave accrual.</li> </ul>	April 1997 March 1998 December 1999	Incomplete; draft regulation amendment prepared but not passed.	Legislation not passed.

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>Chuuk, Kosrae, Pohnpei, Yap</b> <ul style="list-style-type: none"> <li>Replace overtime payments with compensatory time in lieu of cash.</li> <li>Maintain compensatory time in lieu of cash policy.</li> <li>Maintain compensatory time in lieu of cash policy.</li> </ul>	April 1997 March 1998 December 1999	Completed for Kosrae and Pohnpei; some cash payment in Chuuk and in Yap.	Largely not carried out as impractical to build up large time in lieu for service workers such as hospital and police.
<b>Kosrae</b> <ul style="list-style-type: none"> <li>Replace merit wage increase with merit award.</li> <li>Ensure the approved budget reflects merit award.</li> <li>Ensure the approved budget reflects merit award.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Money was put in budget but policy not implemented.
<b>Pohnpei</b> <ul style="list-style-type: none"> <li>Reduce regular and contract service salaries by 12.5%.</li> <li>Ensure the approved budget reflects the personnel expenditure reduction of 12.5%.</li> <li>Ensure the approved budget reflects the personnel expenditure reduction of 12.5%.</li> </ul>	April 1997 March 1998 December 1999	10% cut in place following a 20% cut for 7 months of FY1997; same salaries but hours reduced.	Progress made by cutting hours worked but target not met. Some reversal of gains made.
<b>Chuuk</b> <ul style="list-style-type: none"> <li>Reduce wage bill by 20% from FY1995:               <ul style="list-style-type: none"> <li>(i) Reduce work days from 5 to 4 per week for public service by mid-1996, and</li> <li>(ii) Reduce exempt employees' wages by 20% by mid-1996.</li> </ul> </li> <li>Approved budget reflects in wages bill.</li> <li>Approved budget reflects in wages bill.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Progress made but target not met. Some reversal of gains made.
<b>3. Other Cost Reduction</b>			
<b>Chuuk, Kosrae, Pohnpei</b> <ul style="list-style-type: none"> <li>Complete report analyzing all operating subsidies/transfers from the government</li> <li>Eliminating all operating subsidies and transfers.</li> <li>Maintain elimination of operating subsidies and transfers.</li> </ul>	April 1997 March 1998 December 1999	Incomplete. Pohnpei reducing key subsidies. Economic management policy advisory team for (EMPAT) study and Asian Development Bank (ADB) privatization study.	Carried out by TA 3201. Some reduction of subsidies and transfers but elimination not achieved. However, many subsidies will end as a result of reduced United States Federal grants.
<b>Kosrae</b> <ul style="list-style-type: none"> <li>Review leave accrual provisions of executive service regulations.</li> <li>Revise leave accrual.</li> </ul>	April 1997 March 1998	Completed.	Undertaken.
<b>Pohnpei</b> <ul style="list-style-type: none"> <li>Restrict leave accrual to a maximum of 80 hours.</li> <li>Ensure the approved budget reflects reduced leave accrual.</li> <li>Ensure the approved budget reflects reduced leave accrual.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Undertaken.

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>B. Increase Domestic Revenue Generation</b>			
<b>1. National Taxes</b>			
<b>National Government</b>			
<ul style="list-style-type: none"> <li>Review current taxation legislation and draft reforms for imports and sales tax.</li> </ul>	April 1997	} Completed; value-added tax under consideration.	Change in calculation basis for import duty from free-on-board to cost, insurance and freight implemented. Value-added tax proposal did not get sufficient support in the constitutional referendum. Issue to be revisited.
<ul style="list-style-type: none"> <li>Pass legislation to introduce reforms.</li> </ul>	March 1998		
<b>Chuuk, Kosrae, Pohnpei, Yap</b>			
<ul style="list-style-type: none"> <li>Support amendments to national tax legislation.</li> </ul>	April 1997	} Completed.	Undertaken with respect to import duty. Not applicable with respect to value-added tax.
<ul style="list-style-type: none"> <li>Support amendments to national tax legislation.</li> </ul>	March 1998		
<b>2. State Taxes</b>			
<b>Chuuk, Yap</b>			
<ul style="list-style-type: none"> <li>Complete report analyzing all state taxes and recommending revisions or additions to increase revenue.</li> </ul>	April 1997	} Completed.	Some progress made in Chuuk but none in Yap.
<ul style="list-style-type: none"> <li>Increase state revenues.</li> </ul>	March 1998		
<ul style="list-style-type: none"> <li>Increase state revenues.</li> </ul>	December 1999		
<b>Kosrae</b>			
<ul style="list-style-type: none"> <li>Review state tax system to improve efficiency and effectiveness.</li> </ul>	April 1997	} FY1998 revenues fell; action by Legislature required.	No change in local tax revenue.
<ul style="list-style-type: none"> <li>Increase state revenues by 5% above the FY1995 levels.</li> </ul>	March 1998		
<ul style="list-style-type: none"> <li>Maintain state tax revenues at or above the FY1997 levels.</li> </ul>	December 1999		
<b>Pohnpei</b>			
<ul style="list-style-type: none"> <li>Complete report analyzing all state taxes and recommending revisions or additions to increase revenue.</li> </ul>	April 1997	} Completed.	State tax revenue has approximately doubled.
<ul style="list-style-type: none"> <li>Increase state revenues by 10% above the FY1995 levels.</li> </ul>	March 1998		
<ul style="list-style-type: none"> <li>Increase state revenues by 20% above the FY1995 levels.</li> </ul>	December 1999		
<b>Yap</b>			
<ul style="list-style-type: none"> <li>Improve the collection rate for existing taxes.</li> </ul>	April 1997	} Cannot be estimated.	Cannot be estimated but no change in state tax revenue.
<ul style="list-style-type: none"> <li>Enforce a collection rate of at least 80% of levied taxes.</li> </ul>	March 1998		
<ul style="list-style-type: none"> <li>Enforce a collection rate of at least 80% of levied taxes.</li> </ul>	December 1999		

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
3. User Fees			
Chuuk			
<ul style="list-style-type: none"><li>Complete report analyzing all user fees and recommending revisions or additions to increase revenue.</li></ul>	April 1997	} Completed; no increase in fee levels but increased collection.	Other nontax revenue has fallen but user fees for utilities do not show up in government accounts.
<ul style="list-style-type: none"><li>Increase state public service user fees.</li></ul>	March 1998		
<ul style="list-style-type: none"><li>Increase state public service user fees.</li></ul>	December 1999		
Kosrae			
<ul style="list-style-type: none"><li>Review public service user fees to identify appropriate pricing structure.</li></ul>	April 1997	} Incomplete; fuel tax to cover 50% of road maintenance, hospital, and radio fees to rise.	Some increase in other nontax revenue. Information on service costs is not available.
<ul style="list-style-type: none"><li>Increase user fee revenues to 60% of service cost.</li></ul>	March 1998		
Pohnpei			
<ul style="list-style-type: none"><li>Complete report analyzing all user fees and recommending revisions or additions to increase revenue.</li></ul>	April 1997	} Fees for medical services and outer-island shipping increased.	No change to other nontax revenue but utility charges do not show up in government accounts.
<ul style="list-style-type: none"><li>Increase user fee revenues by 10% from the FY1995 levels.</li></ul>	March 1998		
<ul style="list-style-type: none"><li>Increase user fee revenues by 20% from the FY1995 levels.</li></ul>	December 1999		
Yap			
<ul style="list-style-type: none"><li>Analyze all public service user fees and consider revisions or additions to increase revenue.</li></ul>	April 1997	} Cannot be estimated.	Other nontax revenues have fallen.
<ul style="list-style-type: none"><li>Enforce a collection rate of at least 80% of levied fees.</li></ul>	March 1998		
<ul style="list-style-type: none"><li>Enforce a collection rate of at least 80% of levied fees.</li></ul>	December 1999		
4. Other Charges			
Chuuk, Pohnpei			
<ul style="list-style-type: none"><li>Complete report analyzing all other charges and recommending revisions or additions to increase revenues.</li></ul>	April 1997	} Completed.	Reportedly undertaken but any increases not reflected in increased other nontax revenues.
<ul style="list-style-type: none"><li>Increase other revenues.</li></ul>	March 1998		
<ul style="list-style-type: none"><li>Increase other revenues.</li></ul>	December 1999		
C. Restructure Government Operations and Public Enterprises			
1. Functional and Financial Review of Government Departments			
National Government, Chuuk, Pohnpei, Kosrae, Yap			
<ul style="list-style-type: none"><li>Complete report analyzing existing public service staffing patterns and functions; set FY1997–FY1999 milestones and targets.</li></ul>	April 1997	} Departments reduced from 11 to 7 departments for National Government; 14 to 7 departments in Pohnpei; proposals with governors in Chuuk and Yap; completed in Kosrae.	Some amalgamation of departments in national, Kosrae, and Pohnpei governments. Little evidence of strategic restructuring to provide greater focus on core functions of government.
<ul style="list-style-type: none"><li>Pass legislation approving government restructuring.</li></ul>	March 1998		
<ul style="list-style-type: none"><li>Complete government restructuring.</li></ul>	December 1999		

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>Chuuk, Pohnpei, Kosrae, Yap</b> <ul style="list-style-type: none"> <li>Identify government activities to be eliminated, privatized, or transferred to other service providers</li> <li>Divest noncore government activities.</li> <li>Divest noncore government activities.</li> </ul>	April 1997 March 1998 December 1999	Completed in Pohnpei; ongoing in other states.	Minor progress made with contracting out some services.
<b>2. Functional and Financial Review of Public Enterprises</b>			
<b>National Government, Chuuk, Pohnpei, Yap</b> <ul style="list-style-type: none"> <li>Initiate review of public enterprise staffing patterns, operating costs, service provision, subsidy receipts, and other revenues.</li> <li>Complete report and make recommendations to improve their economic and financial efficiency.</li> <li>Implement recommendations.</li> </ul>	April 1997 March 1998 December 1999	Ongoing. ADB data awaited. May 1999 review by EMPAT. Some state reviews completed.	EMPAT and TA 3201 carried out analysis. TA 3201 supported creation of a public enterprise database. Recommendations not implemented. Will be carried forward by the Private Sector Development Program and Project.
<b>3. Reform of Public Utilities</b>			
<b>Chuuk</b> <ul style="list-style-type: none"> <li>Complete corporate plan for Chuuk Utilities Corporation.</li> <li>Complete annual revision of corporate plan.</li> <li>Complete annual revision of corporate plan.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Corporate plan reportedly produced. Not known if corporate planning process has been maintained.
<b>Kosrae</b> <ul style="list-style-type: none"> <li>Kosrae Utility Authority to prepare annual operations report.</li> <li>Complete annual operations report as part of Kosrae Utility Authority budget process.</li> <li>Complete annual operations.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Annual operations report reportedly produced. Not known if the process has been maintained.
<b>Pohnpei</b> <ul style="list-style-type: none"> <li>Complete corporate plan for Pohnpei Utilities Corporation.</li> <li>Complete annual revision of corporate plan.</li> <li>Complete annual revision of corporate plan.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Corporate plan reportedly produced. Not known if corporate planning process has been maintained.
<b>Yap</b> <ul style="list-style-type: none"> <li>Complete corporate plan for Yap State Public Sector Commission.</li> <li>Complete annual revision of corporate plan.</li> <li>Complete annual revision of corporate plan.</li> </ul>	April 1997 March 1998 December 1999	Completed.	Corporate plan reportedly produced. Not known if corporate planning process has been maintained.

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>Chuuk, Kosrae, Pohnpei, Yap</b> <ul style="list-style-type: none"><li>• Delegate authority of tariff setting to utility and introduce user-pay policy.</li><li>• Retain pricing autonomy of the utility, with utility charges covering operating costs for providing services.</li><li>• Retain pricing autonomy of the utility, with utility charges covering operating costs for providing services.</li></ul>	April 1997 March 1998 December 1999	} Completed.	Pohnpei and Yap utility corporations reportedly covering direct operating costs. Chuuk has increased rates substantially but is reportedly still a long way from break-even. Kosrae may be close to break-even. However, utilities are exempt from some taxes, do not pay a dividend to the governments and it is not known if they expense depreciation.
<b>D. Mitigate Social and Economic Impact</b>			
<b>1. Early Retirement Program</b>			
<b>National Government, Chuuk, Pohnpei, Kosrae, Yap</b> <ul style="list-style-type: none"><li>• Establish early retirement scheme (ERS), including financing requirements and identification of eligible staff.</li><li>• Offer early retirement to public sector staff and complete report on progress.</li><li>• Complete report on progress.</li></ul>	April 1997 March 1998 December 1999	} Completed.	Undertaken.
<b>Kosrae</b> <ul style="list-style-type: none"><li>• Offer staff over 55 years of age an annuity equivalent to Federated States of Micronesia social security pension, payable until recipients become eligible for social security.</li><li>• Continue annuity program for 55+ years.</li><li>• Continue annuity program for 55+ years.</li></ul>	April 1997 March 1998 December 1999	} Completed voluntary program; now extended to mandatory retirement.	Undertaken.
<b>Pohnpei</b> <ul style="list-style-type: none"><li>• Make adequate budget provision for local contribution to ERS.</li><li>• 40% of ERS offerees left government service.</li><li>• 100% of ERS offerees left government service.</li></ul>	April 1997 March 1998 December 1999	} Completed	Undertaken.
<b>2. Outplacement and Counseling Services</b>			
<b>National Government, Chuuk, Pohnpei, Kosrae, Yap</b> <ul style="list-style-type: none"><li>• Design staff retraining, skill upgrading, and associated training program.</li><li>• Implement training programs.</li><li>• Implement training programs.</li></ul>	April 1997 March 1998 December 1999	} Ongoing.	Little training provided.



Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
<b>National Government, Chuuk, Pohnpei, Kosrae, Yap</b> <ul style="list-style-type: none"> <li>Establish employee outplacement services.</li> <li>Provide information on outplacement and counseling services.</li> <li>Provide information on outplacement and counseling services.</li> </ul>	April 1997 March 1998 December 1999	} Ongoing.	Largely did not take place.
<b>E. Foster Development of Private Sector</b>			
<b>1. Investment Climate</b>			
<b>National Government, Chuuk, Pohnpei, Yap</b> <ul style="list-style-type: none"> <li>Review and revise foreign investment procedures.</li> <li>Reform current foreign investment guidelines.</li> </ul>	April 1997 March 1998	} Completed.	Revised legislation enacted but effect reduced by unfavorable regulation. No evidence of increased foreign investment.
<b>Pohnpei</b> <ul style="list-style-type: none"> <li>Draft land leasehold system legislation to provide for 50-year leases and improved transferability.</li> <li>Passed revised legislation.</li> </ul>	April 1997 March 1998	} Completed.	Undertaken but little if any impact.
<b>Yap</b> <ul style="list-style-type: none"> <li>Introduce eminent domain act.</li> <li>Passed eminent domain act.</li> </ul>	April 1997 March 1998	} Incomplete; submitted to legislature.	Not passed despite several attempts.
<b>2. Financing</b>			
<b>National Government, Chuuk, Pohnpei, Kosrae, Yap</b> <ul style="list-style-type: none"> <li>Review loan guarantee and other financing schemes for small entrepreneurs.</li> <li>Complete review and implement a commercial loan guarantee or similar scheme for small entrepreneurs.</li> </ul>	April 1997 March 1998	} Legislation submitted in National Government. Operational in Pohnpei. In progress in Kosrae and Yap. Under review in Chuuk.	Still only in existence in Pohnpei. Relevance questioned.
<b>Chuuk, Kosrae, Pohnpei, Yap</b> <ul style="list-style-type: none"> <li>Review constraints on using land as collateral by banks and commercial lending organizations.</li> <li>Pass revised legislation to enable land to be used as collateral by banks and commercial lending organizations.</li> </ul>	April 1997 March 1998	} Assisted by ADB technical assistance; proposed in Kosrae.	Only Chuuk has passed legislation (Land Lease and Mortgage Act). Land information system improvement incorporated as part of the Private Sector Development Program.
<b>3. Infrastructure</b>			
<b>National Government, Chuuk, Pohnpei, Kosrae, Yap</b> <ul style="list-style-type: none"> <li>Develop a public sector investment program (PSIP).</li> <li>Implement PSIP in the approved development budget.</li> <li>Implement PSIP in the approved development budget.</li> </ul>	April 1997 March 1998 December 1999	} Completed.	PSIPs prepared but limited impact on public sector investment.

Policy and Institutional Reform	Target Date for Accomplishment	Status at the Time of Program Completion Report (February 2000)	Status as of May 2003
4. Human Resource Development			
National Government, Chuuk, Pohnpei, Kosrae, Yap			
• Revise school curricula to increase emphasis given to vocational and technical education.	April 1997	Incomplete; strategies prepared.	Little progress made.
• Increase support for vocational and technical education in approved budget.	March 1998		
• Increase support for vocational and technical education in approved budget.	December 1999		
National Government, Chuuk, Pohnpei, Kosrae, Yap			
• Initiate adult education and training programs in vocational and technical areas.	April 1997	Incomplete; Yap, not requested; strategies prepared for others.	Little progress made.
• Increase support for adult education and training in the approved budget.	March 1998		
• Increase support for adult education and training in the approved budget.	December 1999		
National Government, Kosrae, Yap			
• Ensure post-secondary scholarship programs support training in relevant vocational and trade skills.	April 1997	Incomplete.	Little progress made.
• Increase number of scholarships offered to students wishing to study in the key economic development areas.	March 1998		
• Increase number of scholarships offered to students wishing to study in the key economic development areas.	December 1999		

## COMPLIANCE WITH LOAN COVENANTS

Reference	Covenant	Compliance at Program Completion Report Stage	Current Status of Compliance
Loan Agreement (LA), Sec. 4.01(a)	1. The Borrower will cause the Program to be carried out with due diligence and efficiency and in conformity with sound administrative, financial, engineering, environmental, and economic practices.	Complied with.	Complied with.
LA, Sec. 4.01(b)	2. In carrying out the Program and operation of the program facilities, the Borrower will perform, or cause to be performed, all obligations set forth in Schedule 5 of this Loan Agreement (relating to use of counterpart funds, including the establishment of special accounts; implementation according to the policy matrix and policy letter; and monitoring and review.	Complied with.	Complied with except as noted in Appendix 1.
LA, Sec. 4.02	3. The Borrower will make available, promptly as needed, the funds, facilities, services, and other resources that are required, in addition to the proceeds of the loan, for the carrying out of the Program.	Complied with.	Complied with.
LA, Sec. 4.03	4. The Borrower will ensure that the activities of its departments and agencies for carrying out the Program are conducted and coordinated in accordance with sound administrative policies and procedures.	Complied with.	Complied with.
LA, Sec. 4.04(a)	5. The Borrower will maintain, or cause to be maintained, records and documents adequate to identify the eligible items financed out of the proceeds of the loan and to record the progress of the Program.	Complied with.	Complied with.
LA, Sec. 4.04(b)	6. The Borrower will enable the representatives of the Asian Development Bank (ADB) to inspect any relevant records and documents referred to in paragraph (a) of this section.	Complied with.	Complied with.
LA, Sec. 4.05	7. The Borrower will furnish, or cause to be furnished, to ADB all such reports and information as ADB will reasonably request concerning (i) the loan, and the expenditure of the proceeds, and maintenance of the	Complied with.	Complied with.

Reference	Covenant	Compliance at Program Completion Report Stage	Current Status of Compliance
	<p>service thereof; (ii) the goods financed out of the proceeds of the loan; (iii) the counterpart funds and the use thereof; (iv) the implementation of the Program, including the accomplishment of the targets, and carrying out of the actions set out in the policy letter and program matrix; (v) financial and economic conditions in the territory of the Borrower and the international balance-of-payments position of the Borrower; and (vi) any other matters related to the purposes of the loan.</p>		
LA, Sec. 4.05(b)	<p>8. Without limiting the generality of the foregoing, the Borrower will furnish, or cause to be furnished, to ADB quarterly reports on the carrying out of the Program and on the accomplishment of the targets and carrying out of the actions set out in the policy letter and program matrix. Such reports will be submitted in such form and detail and within such a period as ADB will reasonably request, and will indicate, among other things, progress made and problems encountered during the quarter under review, steps taken or proposed to be taken to remedy these problems, and the proposed program of activities and expected progress during the following quarter.</p>	<p>Party complied with. Regular reports were submitted by each state government. However, the National Government failed to provide regular consolidated quarterly reports to ADB.</p>	<p>As stated by the program completion report (PCR).</p>
LA, Sec. 4.05(c)	<p>9. Promptly after the closing date for withdrawals from the loan account but in any event not later than 3 months thereafter or such later date as may be agreed for this purpose between the Borrower and ADB, the Borrower will prepare and furnish to ADB a report, in such form and in such detail as ADB will reasonably request, on the execution and initial operation of the Program, including its cost, the performance by the Borrower of its obligations under this Loan Agreement, and the accomplishment of the purposes of the loan.</p>	<p>Partly complied with. The states prepared their individual closeout reports. The National Government will consolidate all reports and submit this to ADB by January 2000.</p>	<p>The consolidated report was not seen although it was reportedly prepared.</p>

Reference	Covenant	Compliance at Program Completion Report Stage	Current Status of Compliance
LA, Sec. 4.06(a)	10. It is the mutual intention of the Borrower and ADB that no other external debt owed a creditor other than ADB will have any priority over the loan by way of a lien on the assets of the Borrower. To that end, the Borrower undertakes (i) that, except as ADB may otherwise agree, if any lien will be created on any assets of the Borrower as security for any external debt, such lien will <i>ipso facto</i> equally and ratably secure the payment of the principal of, and service charge and any other charge on, the loan; and (ii) that the Borrower, in creating or permitting the creation of any such lien, will make express provision to that effect.	Complied with.	Complied with.
LA, Sec. 4.06(b)	11. The provisions of paragraph (a) of this section will not apply to (i) any lien created on property, at the time of purchase thereof, solely as security for payment of the purchase price of such property; or (ii) any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after its date.	Complied with.	Complied with.
LA, Sec. 4.06(c)	12. The term “assets of the Borrower” as used in paragraph (a) of this section includes assets of any political subdivision or any agency of the Borrower and assets of any agency of such political subdivision, including any central bank that may be established by the Borrower and such term included assets held on behalf of the Borrower with any foreign or local commercial bank or institution for the time being performing the functions of a central bank for the Borrower, provided that if for any constitutional or other legal reasons, such provision cannot be made with respect to any lien created on assets of any of its political subdivisions, the Borrower will promptly and at no cost to ADB secure the principal of, and service charge on, the loan by an equivalent lien on other assets of the Borrower satisfactory to ADB.	Complied with.	Complied with.

Reference	Covenant	Compliance at Program Completion Report Stage	Current Status of Compliance
LA, Schedule 5, para. 1(a)	13. Immediately after the effective date, the Borrower will establish, in a manner satisfactory to ADB, a special account at Hawaiian Trust Company for the specific purpose of depositing and using the counterpart funds.	Complied with.	Complied with.
LA, Schedule 5, para. 1(b)	14. Whenever the Borrower withdraws proceeds of the loan from the loan account, the Borrower will promptly deposit into the special account the dollar amount equivalent to the amount of the proceeds so withdrawn. The Borrower will maintain, or cause to be maintained, records and documents adequate to identify the eligible items financed out of the proceeds of the Loan and to record the progress of the Program.	Complied with.	Complied with.
LA, Schedule 5, para. 1(c)	15. Except as the Borrower and ADB may otherwise agree, the counterpart funds shall be used, or otherwise obligated, not later than 31 July 1999 to meet the expenditures to be incurred pursuant to the provisions of para. 2 above.	Complied with. Program completion was extended to 31 December 1999.	Complied with.
LA, Schedule 5, para. 1(d)	16. Separate accounts and records for the special account will be maintained in accordance with consistently maintained sound accounting principles and will be audited annually by independent auditors, whose qualifications, terms of reference, and experience are acceptable to ADB, in accordance with sound auditing standards. Certified copies of such audited accounts and records will be furnished to ADB promptly after their preparation but in any event not later than 6 months after the close of the fiscal year to which they relate, or not later than 6 months after the date of the closing of the loan account, as the case may be.	Complied with. General audits of Government accounts have been completed.	Complied with.
LA, Schedule 5, para. 2(a)	17. The Borrower shall ensure that the counterpart funds are (i) used in support of the reforms set forth in the policy letter and program matrix; and (ii) allocated among the Borrower and the states as follows: the Borrower, \$3,000,000; State of Chuuk, \$5,300,000;	Complied with.	Because the early retirement scheme targets were not fully met, and planned training generally did not take place, not all counterpart funds were required by the states.

Reference	Covenant	Compliance at Program Completion Report Stage	Current Status of Compliance
	<p>State of Kosrae, \$2,000,000; State of Pohnpei, \$4,20,000; and State of Yap, \$3,500,000.</p> <p>The Borrower, ADB, and the states will review, and agree on adjustment if necessary, such allocations prior to release of the proceeds of the second tranche.</p>		The unutilized balances were credited to special accounts in each state's name established under Schedule 5, para. 3 below.
LA, Schedule 5, para. 2(b)	18. The Borrower will make appropriate arrangements with the states to ensure that the counterpart funds allocated to the states are disbursed to them upon their compliance with their obligations set forth in the policy letter and program matrix, encompassing achievement and maintenance by the Borrower and the states of sufficient progress in the carrying out of the Program (including the Borrower's and state's maintenance of constraints on spending introduced under the Program). Such funds will be made available to the states on terms and conditions satisfactory to the Borrower, ADB, and the states.	Complied with.	Complied with.
LA, Schedule 5, para. 3	19. The states will establish, no later than such date as the Borrower and ADB may agree upon, accounts into which the states will provide, during the remainder of the period of funding under the Compact, funds equivalent to savings realized under the Program and sufficient to repay to the Borrower the counterpart funds.	Complied with. The same accounts established by the National Government for each state from which to drawdown the counterpart funds will be used to deposit accumulated savings.	Largely complied with. Chuuk state has not made full payment pending what it sees as a need for clarification on the accounts. In any case, any outstanding balance will be deducted from the investment returns due to Chuuk state.
LA, Schedule 5, para. 4	20. Except as ADB may otherwise agree, the Borrower and the states will implement the Program in accordance with the policy letter and program matrix.	Complied with.	Complied with in respect of the stabilization component. Less than complete compliance in the areas of private sector development, restructuring government, and mitigating the social and economic impacts.

Reference	Covenant	Compliance at Program Completion Report Stage	Current Status of Compliance
LA, Schedule 5, para. 5	21. The Borrower will continue policy dialogue with ADB on problems and constraints encountered during implementation of the Program and on desirable changes to overcome or mitigate such problems and constraints.	Complied with.	Complied with.
LA, Schedule 5, para. 6	22. The Borrower and the states shall carry out a review of the following no later than 30 November 1997 or such other date as the Borrower and ADB may agree upon: (a) the progress of the Borrower and the states in implementing the policy reforms set out in the policy letter and program matrix, including fulfillment of the conditions for release of the second tranche, in whole or in part, as set out in para. 7 of Schedule 3 to this Loan Agreement; and (b) the impact of these and earlier reforms on the public sector. To facilitate this review, the Department of Finance of the Borrower will provide ADB with relevant information, in addition to the reports and information referred to in Section 4.05 of this Loan Agreement, in such detail as ADB may reasonably request. This review will form the basis for discussion between the Borrower and ADB on further measures that may be considered necessary or desirable to promote the continued reform and restructuring of the public sector.	Delayed compliance. ADB and the Borrower undertook the joint review in March 1998.	As stated by the PCR.
LA, Schedule 5, para. 7	23. At the end of the program period, the Borrower and ADB will jointly review the implementation of the Program, consistent with the policy letter and the program matrix. Related to such review, the Borrower will evaluate the benefits of the Program upon its completion in accordance with a schedule and terms of reference to be agreed upon by the Borrower and ADB.	Complied with. Joint review done during the PCR preparation.	As stated by the PCR.



## KEY PROVISIONS OF COMPACT II

1. The following text is derived from a statement of Albert V. Short, Negotiator for the Compact of Free Association (Compact), United States (US) Department of State, before the Sub-Committee on Asia and the Pacific of the International Relations Committee US House of Representatives June 18, 2003.<sup>1</sup>

2. The Compact between the US and the Federated States of Micronesia (FSM), as amended, provides for continued economic assistance from fiscal year (FY) 2004 through FY2023. In addition, the economic package provides for annual contributions to a trust fund that will provide an ongoing source of revenue, to be used for the same purposes as the previous grant assistance when the annual grant assistance ends in FY2023. Federal services and program assistance also continue, if provided by the US Congress.

### A. Compact Funding

3. Compact funding will ensure economic and social stability and a smooth transition to FY2024 when annual payments from the US will have terminated and the trust fund becomes a source of revenue. The FSM will receive \$76.7 million in sectoral grants and \$16 million for its trust fund annually beginning in FY2004. Beginning in FY2007, the FSM sector grants decrease by \$800,000 per year through FY2023, with this decrease added to the trust fund. These amounts are partially adjusted for inflation: two thirds of the implicit price deflator will be applied as in the original Compact period. Under the Compact, as amended, the US contributions to the trust funds are conditioned on the FSM contributing at least \$30 million to the FSM trust fund prior to 30 September 2004.

4. Under the Compact, grant assistance will be used for six sectors, with priorities in the education and health sectors and tied to specific outcomes and purposes, and monitored by the Department of the Interior. Misuse of Compact funds can lead to withholding of funds until the problem is resolved. The FSM have agreed to cooperate with the US on criminal investigations regarding misuse of funds, if necessary. The Administration is putting in place an effective accountability mechanism with respect to future US economic assistance to the FSM under the Compact.

5. Economic assistance will no longer be made available through transfers that commingle US funds with local funds, thereby rendering it difficult to track and monitor their use. Instead, future funds under the Compact will be provided through targeted, sectoral assistance, each with a clearly defined scope and objectives. In the amended Compact, the FSM and US have agreed that any future grant assistance will be used in six sectors: health, education, infrastructure, private sector development, public sector capacity building, and the environment. Built into each sectoral grant will be regular planning, monitoring, and reporting requirements. The amended Compact also provides the necessary authority and resources to ensure effective oversight and reasonable progress toward the agreed objectives.

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<sup>1</sup> (Distributed by the Bureau of International Information Programs, US Department of State. Web site: <http://usinfo.state.gov>)

**B. Trust Fund**

6. A major element of the new Compact provisions is the termination of annual mandatory payments to the FSM at the end of FY2023 and the establishment of a trust fund to provide an ongoing source of revenue starting in FY2024. In its earlier proposals to the US, the FSM anticipated the US interest in the termination of mandatory annual financial assistance by proposing that the US capitalize a trust fund over the next term of Compact assistance. Under the amended Compact, the Administration has agreed that annual US financial assistance will terminate at the end of FY2024, and thereafter the trust fund will provide an ongoing source of revenue.

**C. Immigration**

7. Under the Compact, as amended, the US will now require passports for FSM citizens seeking admission as nonimmigrants to the US. Further, naturalized citizens of the FSM will, with certain limited exceptions, now be ineligible for visa-free admission to the US.

# KEY INDICATORS

44

Appendix 4

**Table A4.1: National Gross Domestic Product**  
(current and constant price [FY1998] estimates in \$ million)

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 Est	FY02 Est	FY03 Proj
<b>FSM</b>										
Private Sector	66.6	68.8	66.2	60.9	62.2	63.7	73.6	74.0	72.6	77.3
Compensation of Employees	27.4	26.4	26.2	25.1	25.2	26.8	30.1	31.7	31.8	0.0
Operating Surplus	39.2	42.4	40.0	35.8	37.0	37.0	43.5	42.4	40.8	0.0
Public Enterprises	11.8	14.6	15.7	17.5	18.1	18.7	19.2	19.8	18.8	19.7
Government	59.5	63.9	64.2	59.3	50.7	50.8	53.1	56.1	58.7	59.3
Municipalities and Agencies	2.9	3.0	2.9	3.0	2.8	3.0	3.5	4.0	3.9	4.0
Nonprofits	5.2	5.8	6.3	6.9	7.5	8.1	9.0	9.8	11.3	12.4
Subsistence	28.2	29.1	29.9	30.8	31.4	32.0	32.7	33.5	33.7	34.3
Home Ownership	18.1	18.7	19.3	19.8	20.2	20.7	21.1	21.7	21.8	22.2
Indirect Taxes (net)	15.4	14.9	14.6	14.3	16.2	17.4	21.0	20.1	17.9	18.7
Subsidies	(4.9)	(4.9)	(6.3)	(3.9)	(3.4)	(4.3)	(5.9)	(5.9)	(5.9)	(5.9)
Nominal GDP	202.8	213.9	212.8	208.5	205.8	210.2	227.3	233.2	232.8	242.0
Nominal GDP per capita (\$)	1,921.7	2,022.2	2,007.0	1,962.2	1,932.0	1,968.8	2,124.1	2,174.1	2,165.5	2,245.2
Inflation Index	90.7	93.2	95.8	98.4	100.0	101.9	103.7	105.8	105.9	107.4
Inflation Rate (%)	2.6	2.8	2.8	2.7	1.6	1.9	1.8	2.0	0.0	1.5
Population	105,506	105,755	106,004	106,254	106,505	106,756	107,008	107,260	107,513	107,767
Population Growth Rate (%)	2.0	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
<b>Real GDP</b>	<b>223.6</b>	<b>229.4</b>	<b>222.0</b>	<b>211.9</b>	<b>205.8</b>	<b>206.2</b>	<b>219.1</b>	<b>220.4</b>	<b>220.0</b>	<b>225.2</b>
<b>Real GDP Growth Rate (%)</b>	<b>(0.6)</b>	<b>2.6</b>	<b>(3.2)</b>	<b>(4.5)</b>	<b>(2.9)</b>	<b>0.2</b>	<b>6.3</b>	<b>0.6</b>	<b>(0.2)</b>	<b>2.4</b>

Est = estimated, FSM = Federated States of Micronesia, FY = fiscal year, GDP = gross domestic product, Proj = projected.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>

**Table A4.2: Gross Domestic Product by State**  
(current and constant price [FY1998] estimates in \$ million)

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 Est	FY02 Est	FY03 Proj
<b>Chuuk</b>										
Real GDP	67.4	68.0	59.9	55.4	52.7	53.9	64.3	64.6	62.7	63.6
Real GDP Growth Rate (%)	(4.2)	0.9	(11.9)	(7.5)	(4.9)	2.2	0.2	0.5	(3.0)	1.4
<b>Kosrae</b>										
Real GDP	15.9	16.4	17.4	15.5	15.4	15.7	16.9	17.5	17.7	17.4
Real GDP Growth Rate (%)	2.9	2.7	6.1	(11.1)	(0.5)	1.8	8.2	3.1	1.5	(1.8)
<b>Pohnpei</b>										
Real GDP	94.4	100.4	99.1	92.5	90.7	90.3	93.1	92.0	94.4	98.3
Real GDP Growth Rate (%)	(1.0)	6.4	(1.3)	(6.7)	(2.0)	(0.4)	3.0	(1.1)	2.6	4.1
<b>Yap</b>										
Real GDP	36.7	34.6	35.1	35.8	35.8	36.2	36.0	36.3	35.4	35.7
Real GDP Growth Rate (%)	0.0	(5.7)	1.5	2.0	(0.3)	1.3	(0.6)	1.0	(2.7)	0.9

Est = estimated, FY = fiscal year, GDP = gross domestic product, Proj = projected.

Note: Inflation index: 1987-2000 United States consumer price index; 2000-2002 Federated States of Micronesia consumer price index.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>

**Table A4.3: Number of People Employed by Type of Industry**

<b>Item</b>	<b>FY94</b>	<b>FY95</b>	<b>FY96</b>	<b>FY97</b>	<b>FY98</b>	<b>FY99</b>	<b>FY00</b>	<b>FY01</b>	<b>FY02</b>
Agriculture	48	43	35	38	38	33	28	25	27
Fisheries	462	645	494	400	351	337	278	283	266
Manufacturing	512	537	558	566	577	623	879	984	962
Utilities	187	211	274	384	391	402	403	388	383
Construction	1,030	903	808	736	777	761	863	848	733
Auto services	132	118	123	133	148	113	161	130	153
Wholesaling and Retailing	2,609	2,575	2,414	2,418	2,380	2,532	2,607	2,546	2,655
Hotels and Restaurants	504	532	560	525	576	605	658	671	667
Transport	828	957	912	862	809	827	898	868	831
Communications	145	143	143	135	135	137	139	141	141
Banking	217	214	207	202	206	200	185	185	179
Other Financial Services	35	28	30	30	34	38	40	44	45
Real Estate	43	49	45	39	40	39	47	67	63
Business Services	67	62	59	57	59	55	55	65	68
Governments	6,959	7,028	6,993	6,585	6,021	5,816	5,895	6,069	6,194
Municipalities, Agencies	1,024	1,032	978	880	751	786	840	974	1,065
Education	387	441	468	513	558	583	589	607	700
Health	11	15	14	9	9	11	14	15	17
Private Services	263	253	236	256	262	321	385	426	519
Private Non-Profits	253	272	239	254	235	406	256	282	293
Foreign Governments	133	148	141	138	149	153	153	168	182
Unidentified	0	0	0	0	0	0	1	1	0
<b>Total</b>	<b>15,850</b>	<b>16,205</b>	<b>15,730</b>	<b>15,161</b>	<b>14,505</b>	<b>14,778</b>	<b>15,374</b>	<b>15,789</b>	<b>16,141</b>

FY = fiscal year.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>

**Table A4.4: Number of People Employed by Type of Institution**

<b>Level</b>	<b>Type</b>	<b>FY94</b>	<b>FY95</b>	<b>FY96</b>	<b>FY97</b>	<b>FY98</b>	<b>FY99</b>	<b>FY00</b>	<b>FY01</b>	<b>FY02</b>
<b>FSM</b>	Private Sector	6,167	6,148	5,754	5,555	5,534	5,822	6,499	6,634	6,700
	Public Enterprise	794	1,025	1,042	1,107	1,114	1,062	1,010	961	941
	Financial Institutions	159	148	141	141	148	149	142	147	143
	National Government	726	708	679	689	678	830	825	839	805
	State Government	6,229	6,094	5,918	5,497	4,935	4,659	4,698	4,917	5,047
	Municipalities	870	869	796	703	580	621	659	751	810
	Non-Profits	841	925	948	1,003	1,064	1,236	1,134	1,159	1,296
	<b>Total</b>	<b>15,787</b>	<b>15,916</b>	<b>15,278</b>	<b>14,696</b>	<b>14,054</b>	<b>14,378</b>	<b>14,966</b>	<b>15,408</b>	<b>15,741</b>
<b>Chuuk</b>	Private Sector	1,777	1,743	1,459	1,352	1,347	1,417	1,578	1,546	1,583
	Public Enterprise	15	14	56	101	98	108	111	111	112
	Financial Institutions	36	30	23	20	20	21	22	21	22
	National Government	0	0	0	0	0	0	0	0	0
	State Government	2,747	2,830	2,676	2,473	2,251	2,120	2,142	2,374	2,445
	Municipalities	450	421	327	245	118	109	111	92	118
	Non-Profits	367	397	420	431	427	500	435	425	466
	<b>Total</b>	<b>5,391</b>	<b>5,434</b>	<b>4,961</b>	<b>4,623</b>	<b>4,260</b>	<b>4,274</b>	<b>4,399</b>	<b>4,571</b>	<b>4,746</b>
<b>Kosrae</b>	Private Sector	385	389	416	409	410	461	535	558	585
	Public Enterprise	41	101	107	106	138	130	95	70	74
	Financial Institutions	2	1	0	0	0	0	0	0	0
	National Government	0	0	0	0	0	0	0	0	0
	State Government	835	756	783	763	659	633	639	629	640
	Municipalities	40	39	37	36	37	35	36	35	38
	Non-Profits	12	28	6	5	6	10	6	6	5
	<b>Total</b>	<b>1,316</b>	<b>1,314</b>	<b>1,349</b>	<b>1,319</b>	<b>1,251</b>	<b>1,269</b>	<b>1,312</b>	<b>1,297</b>	<b>1,343</b>

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Table A4.4—*Continued*

Level	Type	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02
<b>Pohnpei</b>	Private Sector	2,834	2,832	2,610	2,469	2,422	2,479	2,692	2,786	2,840
	Public Enterprise	629	773	733	723	726	669	619	611	613
	Financial Institutions	108	106	106	109	116	115	108	114	109
	National Government	726	708	679	689	678	830	825	839	805
	State Government	1,519	1,510	1,455	1,346	1,176	1,140	1,169	1,179	1,207
	Municipalities	269	273	311	301	296	348	352	390	428
	Non-Profits	462	500	522	567	632	726	692	728	825
	<b>Total</b>	<b>6,548</b>	<b>6,701</b>	<b>6,417</b>	<b>6,205</b>	<b>6,045</b>	<b>6,307</b>	<b>6,457</b>	<b>6,646</b>	<b>6,825</b>
<b>Yap</b>	Private Sector	1,170	1,184	1,268	1,324	1,355	1,465	1,693	1,744	1,692
	Public Enterprise	110	138	145	177	152	155	184	168	142
	Financial Institutions	13	12	12	12	12	13	12	12	12
	National Government	0	0	0	0	0	0	0	0	0
	State Government	1,127	999	1,004	915	849	766	749	736	755
	Municipalities	111	136	121	121	129	130	160	234	226
	Non-Profits	0	0	0	0	0	0	0	0	0
	<b>Total</b>	<b>2,532</b>	<b>2,467</b>	<b>2,550</b>	<b>2,549</b>	<b>2,498</b>	<b>2,528</b>	<b>2,799</b>	<b>2,894</b>	<b>2,827</b>

FSM = Federated States of Micronesia, FY = fiscal year.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>

**Table A4.5: Nominal Wage Rates by Type of Institution**  
(\$ per year)

Level	Type	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02
<b>FSM</b>	Private Sector	3,936	3,813	3,998	3,957	3,992	4,025	4,085	4,224	4,218
	Public Enterprise	8,242	7,977	8,411	8,730	9,179	9,911	10,625	11,377	11,015
	Financial Institutions	13,167	12,543	13,448	13,566	13,327	14,148	15,537	14,739	14,882
	National Government	13,891	14,774	14,812	14,754	13,870	12,498	11,879	11,972	12,667
	State Government	7,495	8,095	8,182	7,613	7,661	7,620	7,848	7,953	8,176
	Municipalities	3,207	3,294	3,488	4,095	4,590	4,669	5,007	5,049	4,615
	Non-Profits	5,748	5,917	6,202	6,405	6,703	6,244	7,469	7,908	8,113
	<b>Total</b>	<b>6,164</b>	<b>6,383</b>	<b>6,598</b>	<b>6,456</b>	<b>6,497</b>	<b>6,437</b>	<b>6,542</b>	<b>6,699</b>	<b>6,763</b>
<b>Chuuk</b>	Private Sector	2,978	3,068	3,076	2,954	3,022	3,061	3,272	3,337	3,426
	Public Enterprise	5,458	5,503	6,588	7,175	7,945	9,465	10,054	9,925	9,371
	Financial Institutions	12,257	12,329	14,938	13,589	13,124	14,590	16,054	16,159	13,462
	National Government	—	—	—	—	—	—	—	—	—
	State Government	6,397	7,173	7,093	6,106	6,054	5,970	6,599	7,007	7,067
	Municipalities	1,740	1,884	1,634	1,940	2,312	3,028	2,345	2,102	2,022
	Non-Profits	3,168	3,228	3,327	3,335	3,555	3,205	3,758	3,984	4,252
	<b>Total</b>	<b>4,698</b>	<b>5,183</b>	<b>5,264</b>	<b>4,761</b>	<b>4,818</b>	<b>4,738</b>	<b>5,151</b>	<b>5,499</b>	<b>5,534</b>
<b>Kosrae</b>	Private Sector	3,122	3,026	3,238	3,181	3,269	3,188	3,122	3,378	3,390
	Public Enterprise	4,804	6,125	5,592	7,828	7,905	8,904	10,749	11,138	10,412
	Financial Institutions	5,855	4,259	—	—	—	—	—	—	—
	National Government	—	—	—	—	—	—	—	—	—
	State Government	6,439	7,236	7,317	7,431	6,715	7,248	7,474	7,669	8,844
	Municipalities	3,977	3,876	4,587	4,322	4,210	4,410	4,538	4,660	3,967
	Non-Profits	1,684	3,209	3,004	1,503	1,747	1,864	2,086	2,456	3,697
	<b>Total</b>	<b>5,307</b>	<b>5,727</b>	<b>5,838</b>	<b>6,049</b>	<b>5,628</b>	<b>5,833</b>	<b>5,840</b>	<b>5,919</b>	<b>6,409</b>

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Table A4.5—Continued

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02
<b>Pohnpei</b>									
Private Sector	4,547	4,447	4,765	4,717	4,629	4,829	4,869	4,995	4,873
Public Enterprise	9,253	8,855	9,663	9,882	10,310	11,025	12,196	13,166	12,257
Financial Institutions	14,033	12,939	13,517	13,958	13,761	14,609	15,879	14,812	15,534
National Government	13,872	14,755	14,792	14,734	13,850	12,481	11,863	11,956	12,649
State Government	11,104	11,151	11,526	10,902	11,767	11,270	11,081	10,888	11,052
Municipalities	5,126	5,050	4,881	5,210	5,143	4,767	5,401	5,214	4,661
Non-Profits	7,908	8,201	8,549	8,778	8,876	8,395	9,848	10,243	10,323
<b>Total</b>	<b>7,972</b>	<b>7,993</b>	<b>8,378</b>	<b>8,331</b>	<b>8,378</b>	<b>8,244</b>	<b>8,336</b>	<b>8,425</b>	<b>8,361</b>
<b>Yap</b>									
Private Sector	4,178	3,654	3,729	3,801	4,037	3,859	3,899	4,049	4,146
Public Enterprise	4,108	4,650	4,887	5,452	5,742	6,257	5,629	5,941	7,263
Financial Institutions	9,738	9,847	9,847	9,847	9,508	9,192	11,532	11,532	11,532
National Government	—	—	—	—	—	—	—	—	—
State Government	6,089	6,740	6,912	6,998	6,971	7,060	6,694	6,543	6,605
Municipalities	4,223	3,972	4,593	5,625	5,511	5,850	6,097	5,993	5,986
Non-Profits	—	—	—	—	—	—	—	—	—
<b>Total</b>	<b>5,057</b>	<b>5,005</b>	<b>5,117</b>	<b>5,178</b>	<b>5,241</b>	<b>5,104</b>	<b>4,920</b>	<b>4,982</b>	<b>5,138</b>

— = not available, FSM = Federated States of Micronesia, FY = fiscal year.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>

**Table A4.6: Balance of Payments**  
(\$ million)

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 est.	FY02 est.
Trade balance	(89.4)	(71.7)	(84.4)	(83.1)	(82.4)	(81.1)	(94.3)	(87.1)	(77.1)
Exports, free-on-board	11.4	20.6	18.1	15.0	16.0	14.5	12.9	16.3	16.1
Imports, free-on-board	(100.8)	(92.3)	(102.6)	(98.1)	(98.5)	(95.5)	(107.2)	(103.4)	(93.2)
Petroleum products	(12.2)	(11.6)	(13.4)	(11.3)	(10.9)	(11.1)	(15.4)	(14.4)	(14.6)
Services account	(25.1)	(16.8)	(21.4)	(30.5)	(34.4)	(29.4)	(27.6)	(27.1)	(26.6)
Receipts	17.6	20.2	22.4	19.6	15.7	17.4	20.7	18.7	20.1
Travel	16.5	18.1	19.1	17.7	14.5	16.0	19.5	16.8	18.2
Communications (net)	0.7	0.8	1.0	0.8	1.1	1.1	1.1	1.8	1.8
Other	0.4	1.4	2.3	1.1	0.1	0.3	0.1	0.1	0.1
Payments	(42.6)	(37.0)	(43.8)	(50.2)	(50.1)	(46.8)	(48.3)	(45.8)	(46.7)
Freight and insurance	(17.8)	(16.3)	(18.1)	(17.3)	(17.4)	(16.9)	(18.9)	(18.3)	(16.4)
Transportation	(8.2)	(9.6)	(9.6)	(12.8)	(9.9)	(10.1)	(10.7)	(11.1)	(11.2)
Travel	(4.5)	(4.8)	(4.8)	(4.9)	(4.8)	(5.0)	(5.3)	(5.5)	(5.5)
Other	(12.1)	(6.3)	(11.3)	(15.1)	(18.0)	(14.8)	(13.3)	(11.0)	(13.5)
Income, net	21.3	24.9	25.2	21.0	21.4	23.4	21.5	11.5	13.0
Receipts	32.1	35.0	34.6	29.3	28.6	29.6	26.6	15.0	16.1
Fishing rights fees	21.3	21.5	20.5	14.4	13.5	15.9	14.1	12.0	11.2
Interest dividend income	10.8	13.5	14.1	14.9	15.1	13.7	12.5	3.0	4.9
Payments	(10.8)	(10.1)	(9.4)	(8.3)	(7.1)	(6.2)	(5.1)	(3.5)	(3.1)
Interest payments	(9.5)	(8.7)	(7.7)	(6.7)	(5.6)	(4.6)	(3.7)	(2.1)	(1.7)
Dividends	(1.3)	(1.4)	(1.7)	(1.6)	(1.5)	(1.6)	(1.4)	(1.4)	(1.4)
Unrequited transfers	93.4	87.1	97.2	72.1	83.5	85.6	87.0	85.3	99.4
Private	1.1	1.2	1.4	1.7	1.9	2.1	2.2	2.2	2.3
Inflows	3.4	3.5	3.7	4.0	4.2	4.4	4.6	4.7	4.8
Outflows	(2.2)	(2.4)	(2.3)	(2.3)	(2.3)	(2.3)	(2.5)	(2.5)	(2.6)
Official	92.3	85.9	95.8	70.5	81.6	83.5	84.8	83.1	97.1
Compact funds	61.4	62.1	62.8	53.6	54.4	54.4	54.7	55.3	65.9
Other	31.0	23.9	33.1	16.9	27.1	29.1	30.1	27.9	31.2
<b>Current Account Balance</b>	<b>0.3</b>	<b>23.5</b>	<b>16.6</b>	<b>(20.5)</b>	<b>(11.9)</b>	<b>(1.4)</b>	<b>(13.3)</b>	<b>(17.4)</b>	<b>8.7</b>

*Continued on next page*

Table A4.6—Continued

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 est.	FY02 est.
<b>Capital and Financial Account</b>	<b>28.0</b>	<b>29.3</b>	<b>32.0</b>	<b>23.1</b>	<b>25.8</b>	<b>19.7</b>	<b>12.2</b>	<b>19.7</b>	<b>36.9</b>
Capital Transfers	39.4	31.4	41.3	30.2	27.9	30.8	29.3	26.5	36.8
Capital Transfers, official	28.8	29.4	29.8	30.2	24.0	24.5	24.5	24.6	31.8
Capital Transfers, in-kind	10.7	2.1	11.6	0.0	3.9	6.3	4.8	1.9	5.0
Short term, net	(1.9)	7.4	6.2	(2.9)	1.3	(0.2)	(0.1)	2.1	0.1
Medium term, net	(9.5)	(9.5)	(15.6)	(4.2)	(3.4)	(10.9)	(17.0)	(8.9)	0.0
Inflows	2.2	0.3	0.8	11.7	11.8	3.8	2.2	0.0	0.0
Medium-term notes (MTN)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other borrowing	2.2	0.3	0.8	11.7	11.8	3.8	2.2	0.0	0.0
Outflows	(11.7)	(9.8)	(16.4)	(15.9)	(15.2)	(14.7)	(19.2)	(8.9)	0.0
MTN amortization	(8.6)	(9.2)	(15.8)	(8.3)	(11.3)	(11.0)	(18.5)	(8.2)	0.0
Other amortization	(3.1)	(0.6)	(0.6)	(7.6)	(3.9)	(3.7)	(0.7)	(0.7)	0.0
<b>Overall balance</b>	<b>92.2</b>	<b>1.1</b>	<b>(9.8)</b>	<b>19.8</b>	<b>(9.4)</b>	<b>(0.1)</b>	<b>(17.8)</b>	<b>(37.7)</b>	<b>24.1</b>
Errors and omissions	(63.8)	51.7	58.3	(17.2)	23.3	18.4	16.7	40.1	21.6

Est = estimated, FY = fiscal year.

Source: Department of Economic Affairs. 2002. *Federated States of Micronesia Economic Review*.

**Table A4.7: External Debt**  
(\$ million)

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
<b>External Debt</b>										
New	2.2	0.3	0.8	11.7	11.8	3.8	2.2	—	—	—
Outstanding	138.8	127.4	118.4	113.7	109.6	98.2	85.7	66.5	53.8	53.1
Amortization	11.7	9.8	16.4	15.9	15.2	14.7	19.2	8.9	0.7	0.7
Interest	9.4	8.7	7.7	6.7	5.6	4.7	3.8	2.1	1.7	1.7
Principal Balance	127.1	117.6	102.0	97.8	94.4	83.5	66.5	57.6	53.1	52.4
Principal Balance (excluding PSRP)	127	118	102	88	76	66	49	40	35	34
External Debt as % of GDP (excluding PSRP)	63	55	48	42	37	31	22	18	15	15
External Debt as % of GDP	63	55	48	47	46	40	30	26	23	22
Debt Service as % of Exports <sup>a</sup>	86	51	68	75	74	69	80	36	8	10
<b>External Debt Adj. Offsetting Assets<sup>b</sup></b>										
New	2.2	0.3	0.8	1.7	3.8	3.8	2.2	—	—	—
Outstanding	80.5	75.7	73.9	66.9	60.9	57.5	51.0	45.3	35.8	35.1
Amortization	2.5	2.6	8.7	9.8	3.9	5.6	5.7	5.7	0.7	0.7
Interest	4.4	4.3	3.9	3.5	2.8	2.6	2.2	1.8	1.5	1.5
Principal Balance	69.0	66.7	58.8	50.7	50.6	48.8	45.3	39.6	35.1	34.4
External Debt as % of GDP	34	31	28	24	25	23	21	18	15	15
Debt Service as % of Exports <sup>a</sup>	28	19	35	44	24	29	27	24	8	9
<b>Memorandum items:</b>										
GDP (current year, \$)	202.5	213.6	212.5	208.1	205.5	209.9	218.6	225.6	227.5	234.0
Exports (goods & services, \$)	24.7	36.1	35.6	30.1	28.1	27.9	28.8	30.8	29.5	24.7

— = not available, Adj = adjusted, FY = fiscal year, GDP = gross domestic product, PSRP = public sector reform program.

<sup>a</sup> Exports of goods and services.

<sup>b</sup> Both Yap Medium-Term Notes and PSRP Program Loan hold assets in offshore investments equal/greater than debt.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>

**Table A4.8: Consolidated General Government Finances**  
(\$ million)

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 est.	FY02 est.	FY03 proj.
<b>A. Total Revenue and Grants</b>	<b>162.4</b>	<b>170.3</b>	<b>162.9</b>	<b>138.7</b>	<b>151.2</b>	<b>149.4</b>	<b>148.2</b>	<b>137.7</b>	<b>160.3</b>	<b>163.7</b>
1. Total revenue	56.0	58.7	54.2	48.7	55.6	53.4	52.0	41.5	46.1	48.4
Tax revenue	21.2	21.1	21.1	20.6	26.1	25.3	27.1	27.8	28.4	28.5
Wages and salary tax	5.7	6.2	5.6	5.4	7.8	5.6	6.3	6.7	6.8	6.4
Gross revenue tax	6.0	6.1	6.0	5.5	5.7	5.8	6.6	6.9	6.9	7.1
Import tax: fuel	0.9	0.7	0.9	0.7	0.8	0.8	0.6	0.7	0.7	0.7
Import tax: all others	4.3	3.8	3.7	4.1	6.3	6.3	7.0	7.3	7.3	7.5
All other tax (national)	0.0	0.3	0.3	0.5	0.2	0.7	0.0	0.1	0.3	0.3
State tax revenue	4.4	4.0	4.6	4.3	5.4	6.0	6.4	6.2	6.3	6.4
Nontax revenue	34.7	37.6	33.1	28.1	29.5	28.2	24.9	13.7	17.8	19.9
Fishing access revenue	21.3	21.5	20.5	14.4	13.5	16.0	14.1	12.0	11.2	12.4
Dividend and interest income	6.6	8.2	8.1	8.7	8.9	7.4	5.2	(2.3)	1.7	2.5
Other nontax revenues	6.8	7.9	4.5	5.1	7.2	4.7	5.6	4.1	4.8	5.0
2. Grants	106.4	111.6	108.7	90.0	95.6	96.0	96.2	96.2	114.2	115.3
Grants from abroad	106.4	111.6	108.7	90.0	95.6	96.0	96.2	96.2	114.2	115.3
Current grants	70.5	77.2	77.2	66.0	71.0	70.9	70.4	69.9	81.1	81.8
Compact General	39.7	44.7	45.3	38.0	37.9	37.5	36.9	37.4	47.7	48.3
Compact Special	17.9	18.3	18.0	18.0	18.2	18.2	17.7	17.8	18.2	18.3
Others: current	12.8	14.3	13.9	9.9	14.9	15.2	15.8	14.6	15.2	15.2
Capital grants	35.9	34.3	31.6	24.0	24.6	25.1	25.8	26.2	33.1	33.5
Compact	33.7	29.8	30.2	22.0	23.3	23.7	24.6	25.0	31.8	32.2
Others: capital	2.2	4.6	1.4	2.0	1.3	1.4	1.1	1.3	1.3	1.3

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Table A4.8—Continued

Item	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01 est.	FY02 est.	FY03 proj.
<b>B. Total Expenditure</b>	<b>(163.0)</b>	<b>(173.4)</b>	<b>(162.4)</b>	<b>(137.9)</b>	<b>(165.3)</b>	<b>(165.3)</b>	<b>(163.2)</b>	<b>(151.3)</b>	<b>(154.8)</b>	<b>(159.6)</b>
1. Current expenditure	(128.3)	(142.2)	(132.8)	(124.4)	(124.9)	(126.6)	(131.9)	(125.5)	(129.1)	(130.7)
Expenditure on goods and services	(114.7)	(130.0)	(119.7)	(113.6)	(109.1)	(114.3)	(119.7)	(119.0)	(122.1)	(124.2)
Wages and salaries	(58.4)	(62.9)	(63.2)	(58.5)	(50.1)	(50.2)	(52.2)	(55.1)	(57.6)	(58.2)
Travel	(5.8)	(6.2)	(5.1)	(6.9)	(6.8)	(7.7)	(8.4)	(8.4)	(8.4)	(8.5)
Other	(50.5)	(60.9)	(51.4)	(48.2)	(52.2)	(56.4)	(59.1)	(55.5)	(56.1)	(57.4)
Interest payments	(7.4)	(6.8)	(5.7)	(4.8)	(3.6)	(2.9)	(1.9)	0.0	0.0	0.0
Subsidies	(4.9)	(4.9)	(6.3)	(3.9)	(3.4)	(4.3)	(5.9)	(3.0)	(3.0)	(3.1)
Transfers	(1.3)	(0.6)	(1.1)	(1.9)	(8.8)	(5.2)	(4.5)	(3.5)	(3.9)	(3.5)
2. Capital expenditure	(34.7)	(31.1)	(29.6)	(13.5)	(40.4)	(38.8)	(31.3)	(25.9)	(25.7)	(28.9)
Acquisition of fixed capital	(7.4)	(8.2)	(4.4)	(3.3)	(21.3)	(14.8)	(9.4)	(8.4)	(7.9)	(8.8)
Multi-purpose development projects	(19.1)	(18.9)	(22.2)	(10.2)	(16.9)	(23.0)	(21.5)	(17.3)	(17.1)	(19.4)
Capital transfers	(8.2)	(4.1)	(3.0)	0.0	(2.2)	(1.0)	(0.5)	(0.2)	(0.7)	(0.7)
3. Net lending (domestic)	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Overall Balance</b>	<b>(0.6)</b>	<b>(3.1)</b>	<b>0.4</b>	<b>0.8</b>	<b>(14.1)</b>	<b>(15.9)</b>	<b>(15.0)</b>	<b>(13.6)</b>	<b>5.5</b>	<b>4.1</b>
Current Balance	(1.8)	(6.3)	(1.5)	(9.7)	1.7	(2.3)	(9.4)	(14.0)	(1.8)	(0.5)
Capital Balance	1.2	3.2	1.9	10.5	(15.8)	(13.6)	(5.6)	0.4	7.4	4.6
<b>Memo items:</b>										
Nominal GDP	202.5	213.6	212.5	208.1	205.5	209.9	223.1	230.1	232.3	241.4
Total revenue and grants as % of GDP	80	80	77	67	74	71	66	60	69	68
Grants as % of GDP	53	52	51	43	47	46	43	42	49	48
Grants as % of total revenue	66	66	67	65	63	64	65	70	71	70
Tax revenue as % of GDP	10	10	10	10	13	12	12	12	12	12
Total expenditure and net lending as % of GDP	(80)	(81)	(76)	(66)	(80)	(79)	(73)	(66)	(67)	(66)
Current expenditure as % of GDP	(57)	(61)	(56)	(55)	(53)	(54)	(54)	(52)	(53)	(51)
Capital expenditure as % of GDP	(4)	(4)	(2)	(2)	(10)	(7)	(4)	(4)	(3)	(4)
Overall balance as % of GDP	(1)	(3)	(1)	(5)	1	(1)	(4)	(6)	(1)	(0)
Current balance as % of GDP	1	2	1	5	(8)	(6)	(2)	0	3	2

est = estimate, FY = fiscal year, GDP = gross domestic product, proj = projection.

Source: 2003. Economic Management and Policy Advisory Team. Available at <http://www.empat.fm/statistics/stats.htm>.

**PROFILE OF EARLY RETIREES**  
**Distribution of Early Retirees by State and Early Retirement Payment Level**

<b>Government</b>	<b>Early Retirement Payment Level</b>	<b>Number of Retirees</b>	<b>Total ERS Amount</b>	<b>Percent of Subtotal</b>	
				<b>Number</b>	<b>Amount</b>
<b>Chuuk<sup>a</sup></b>					
	Less than 10,000	270	1,427,972	91.8	80.4
	10,000-19,999	24	347,879	8.2	19.6
	20,000-29,999	0			
	30,000-39,999	0			
	40,000 and Over	0			
	<b>Subtotal</b>	<b>294</b>	<b>1,775,851</b>	<b>100.0</b>	<b>100.0</b>
<b>Kosrae</b>					
	Less than 10,000	73	481,518	63.5	44.6
	10,000-19,999	40	552,696	34.8	51.2
	20,000-29,999	2	44,567	1.7	4.1
	30,000-39,999	0			
	40,000 and Over	0			
	<b>Subtotal</b>	<b>115</b>	<b>1,078,781</b>	<b>100.0</b>	<b>100.0</b>
<b>Pohnpei</b>					
	Less than 10,000	48	233,825	30.4	10.1
	10,000-19,999	75	1,117,415	47.5	48.4
	20,000-29,999	27	658,804	17.1	28.5
	30,000-39,999	7	228,961	4.4	9.9
	40,000 and Over	1	70,921	0.6	3.1
	<b>Subtotal</b>	<b>158</b>	<b>2,309,926</b>	<b>100.0</b>	<b>100.0</b>
<b>Yap</b>					
	Less than 10,000	68	450,673	52.3	30.9
	10,000-19,999	49	679,574	37.7	46.6
	20,000-29,999	11	265,135	8.5	18.2
	30,000-39,999	2	61,656	1.5	4.2
	40,000 and Over	0			
	<b>Subtotal</b>	<b>130</b>	<b>1,457,038</b>	<b>100.0</b>	<b>100.0</b>
<b>National</b>					
	Less than 10,000	23	165,519	17.4	5.4
	10,000-19,999	42	654,835	31.8	21.5
	20,000-29,999	23	548,666	17.4	18.1
	30,000-39,999	37	1,319,635	28.0	43.4
	40,000 and Over	7	350,691	5.3	11.5
	<b>Subtotal</b>	<b>132</b>	<b>3,039,345</b>	<b>100.0</b>	<b>100.0</b>
<b>Total</b>					
	Less than 10,000	482	2,759,507	58.1	28.6
	10,000-19,999	230	3,352,398	27.7	34.7
	20,000-29,999	63	1,517,172	7.6	15.7
	30,000-39,999	46	1,610,252	5.5	16.7
	40,000 and Over	8	421,612	1.0	4.4
	<b>Total</b>	<b>829</b>	<b>9,660,941</b>	<b>100.0</b>	<b>100.0</b>

ERS = Early Retirement Scheme.

<sup>a</sup> Of the 523 reported number of early retirees, only 294 have information on early retirement payments.

Source: Compiled from records held by national and state governments.

## SOCIOECONOMIC IMPACT ASSESSMENT

### A. Introduction

1. The pre-reform problems of the Federated States of Micronesia (FSM) have deep roots. Analysis of the socioeconomic impact of the Public Sector Reform Program (PSRP), and why certain expected outcomes did not occur, requires a brief consideration of the socioeconomic forces that shaped the FSM over the past 30 years.

2. The four island groups of Yap, Chuuk, Pohnpei, and Kosrae came into contact with the outside world in the sixteenth century. They were ruled by Spain from 1885, by Germany from 1899 to 1914, by Japan from 1914 to 1945, and by the United States (US) as part of the Trust Territory of Micronesia from 1945 to 1987. At that time, the four island groups elected to become a self-governing federation under a Compact of Free Association (the Compact) with the US.

3. During the period of Japanese administration, the Mandated Territory of Micronesia had a strong export economy based on agriculture and fisheries, and Japanese settlers came to outnumber islanders. At the end of World War II, during which the islands had been a major theater of war, their population was in decline, a trend dating from the late nineteenth century. Since the interest of the US in Micronesia was strategic rather than economic, the policy of the administration emphasized social welfare with particular emphasis on public health rather than economic development.

4. In the early 1970s the people of the Trust Territory became eligible for food assistance programs operated by the US Federal Food and Drug Administration, which included free meals for pre-school and school children and the elderly, food stamps, and a range of other social programs including job creation, training, and public health provided by various US federal agencies. These anti-poverty programs were one-size-fits-all; packaged for Chuuk in the same way as they were for Chicago. In retrospect, they may be seen as inappropriate for small island economies, for in effect, the entire population of the Trust Territory became welfare dependent.<sup>1</sup>

5. The net effect of public policy between 1970 and 1990 was a massive change in lifestyle among the population, demonstrated by a steep increase in imports, particularly food and beverages, and a concomitant decline in local production. For example, the value of imported food rose from \$2.2 million for the whole of the Trust Territory in 1963 to over \$20 million for the FSM alone in 1990. The economy grew as the public sector expanded, of which a significant segment grew to administer US federal assistance programs.<sup>2</sup> Most households relied on the government for employment and/or welfare benefits. The main islands in each state rapidly became urbanized, and there was substantial rural to urban migration from the outer islands in most states.<sup>3</sup> From the time of the Compact in 1987, many programs continued to attract US federal funds, others were gradually cut back, and many of those no longer externally funded were picked up in FSM state budgets. As Compact funds declined, these programs became increasingly difficult to finance, but political pressure for their continuation was such that, in

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<sup>1</sup> For example Peoples, James G. 1985. *Islands in Trust: Culture Change and Dependency in a Micronesian Economy*. Boulder & London: Westview Press.

<sup>2</sup> Asian Development Bank. 1993. *Women in Development: Federated States of Micronesia*. Country Briefing Paper. Manila.

<sup>3</sup> On Yap island, traditional leaders tried to restrict outer island migration to the main island by confining migrants to one small, overcrowded settlement and refusing them the same rights as the Yapese.



1993 for example, the Chuuk state government was still spending \$2 million a year on the school hot lunch program and employing 380 people to service it.

6. Although the design of the PSRP included good strategies to win political and public support (which were successful at federal level), at state level, there were powerful obstacles and public resistance. Standards of living enjoyed by the people of the FSM had become, in the space of a generation, almost entirely dependent on aid and public expenditure. The younger generation had no memory and few, if any, of the traditional livelihood skills of the older generation, particularly in Pohnpei and Chuuk where public sector dependence was highest.

7. There was still widespread belief that aid levels could be restored or maintained, and state-level political resistance to the economic realities was a response both to the resistance in the electorate and to a powerful commercial constituency. The most successful locally owned ventures are in the importing and wholesaling sector, and politically influential merchants were unlikely to support a reform agenda that included measures to decrease imports.

8. The following sections present an analysis of the socioeconomic impact of the PSRP based on the comparison of selected indicators for the pre- (1994) and post- (2000) program periods (as summarized in the attached table). A comparison of these indicators shows that the substantial downsizing of the public sector resulted in changes in the characteristics of the country's demography and economic activity, as well as the quality of social services. Relevant socioeconomic studies were also consulted that confirm the impacts identified.

## **B. Impacts on Employment and Private Enterprise**

9. The PSRP provided specific compensation and training/counseling mitigation measures for those leaving public sector employment. However, the increase in private sector activity envisaged in the PSRP design occurred only to a limited extent.

10. Mitigation arrangements assumed that at least a proportion of retirement benefits would be invested in private self-employment, but the evidence points to the contrary. Retirement payments appear seldom to have been used for productive investments. Anecdotal evidence showed that retirees tended to consume their retirement funds by purchasing vehicles and renovating houses. This is supported by the vehicle registration data that showed an increase in the number of private cars registered, from 1,931 units in 1994 to 3,475 in 1998.

11. It is unlikely that more training and counseling, had they been provided, would have had much impact. Despite rapid modernization, the culture of entrepreneurship is weak in the FSM. Business ventures are often entered into with the aim of acquiring social status rather than making a profit, and traditional values of consumption, sharing, and kin-based redistribution of wealth remain strong.<sup>4</sup>

12. One major effect of the early retirement scheme associated with the PSRP was an increase in subsistence farming and fishing, particularly among those retirees who still had the skills and the land to cultivate, and who had no other employment prospects. Those with access to urban markets fished and farmed for local markets as well as for subsistence purposes. The number of pure subsistence workers increased almost 100% from 5,874 in 1994 to 10,624 in 2000, thus its share to total employment improved from 27% in 1994 to 36%. Also, the number of persons engaged in market-oriented subsistence activities increased from 1,501 to 4,592,

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<sup>4</sup> Peterson, Glenn. 1986. Redistribution in a Micronesian Commercial Economy. *Oceania*, Vol. 57.

with its share going up to 16% in 2000, from a level of 7% in 1994. Overall, the share of total subsistence workers increased from 34% in 1994 to 52% in 2000. By gender, the share of female subsistence workers increased from 32% in 1994 to 54% in 2000.

13. Despite the contraction in government spending, labor force participation rate of persons 15 years old and over increased from 44% in 1994 to 59% in 2000. The bulk of the increase came from the increased labor participation rates of female workers (from 30% in 1994 to 50% in 2000) and the youngest group with ages 15 to 19 (from 18% to 33%). The growth in the labor force was absorbed by the increase in the number of people engaged in subsistence activity. The share of profits from small businesses and farming, as source of income increased to 16% in 2000 from 8% in 1994. The share of employed persons in the private sector improved slightly, from 44% in 1994 to 47% in 2000.

14. The employment rate dropped from 84% in 1994 to 78% in 2000. The decline was mainly due to the contraction of the formal sector, largely dominated by the public sector. The share of formal work force to total employment decreased significantly from 66% in 1994 to 48% in 2000. On the other hand, the lack of opportunities in the formal sector resulted in an increase in subsistence activities.

15. Changes in the distribution of employees by industry within the formal sector also occurred. Public administration dropped due to the downsizing of public sector, from 27% in 1994 to 24% in 2000. The share of other service activities also went down from 13% to 5%. The decline in these activities, however, was compensated for by the increased share of wholesale and retail trade activities, from 8% in 1994 to 13% in 2000.

### **C. Impacts on Migration**

16. The second major impact was a sharp increase in migration. Evidence is derived from demographic data. The substantial slowdown in the population growth rates, from 1.9% per year from 1994 to a low rate of 0.2% in 2000 may be attributed to massive outward migration, eased by the Compact provisions allowing FSM citizens migration access to the US and its territories. It has been estimated that the number of migrants to Guam, Commonwealth of Northern Marianas Islands, and the US (including Hawaii) increased by more than 100%, from about 11,000 in 1994 to about 26,000 in 2000. The downturn in economic activity during the PSRP period resulted in extensive migration, the objective of which was to look for employment opportunities in neighboring US territories as well as in the US.

17. The resident population of FSM increased slightly from 105,506 in 1994 to 107,008 in 2000. The fertility rate decreased only marginally (for all women) from 4.6 children per woman in 1994 to 4.4 in 2000. However, for women in the labor force, the decline in fertility rate was much higher, from 3.4 children per woman to 2.5. Similarly, crude birth rate decreased from 31 per 1,000 in 1994 to 28 per 1,000 in 2000. Life expectancy increased from 65 to 67 years while the infant mortality rate dropped from 46 per 1,000 in 1994 to 40 per 1,000 in 2000. Although there was a slight improvement in infant mortality rate, the decline was unsatisfactory as the rate is still considered as one of the highest in the Pacific.

18. In 2000, 40% of individuals derived their income from remittances, while 33% from wages and salaries. This was a significant change from the 1994 census, which showed that wages and salaries accounted for 59% of those who reported receiving income in 1994. There was an increase in the number of people who reported having income, but much of the increase appears to have come from increased remittances. Outward migration had a positive impact on

the economy as the remittances compensated for the decline in income of the resident population. It also lessened the competition for the limited job opportunities. Income sources have become more diversified.

#### **D. Poverty and Gender**

19. No hard data on poverty impacts was available, however studies done prior to the reform<sup>5</sup> suggest that those most likely to have been disadvantaged by the reforms are outer island migrants, among which the poor are most numerous. An estimated 15,000 people originating from the outer islands have settled on the major islands in each state over the past 40 years. They migrated to obtain employment and other benefits. Most live in crowded informal settlements and few have access to agricultural land where they have settled. They also lack productive land in their overpopulated home atolls. Accordingly, they have the most limited economic alternatives to wage employment of any population segment.

20. It is hard to assess poverty on income data in the FSM because of family support systems and the subsistence living available to those with access to land. What is clear is that, overall, people are considerably less well-off financially than in 1994 due to changes in economic activity. The number of persons receiving income below \$1,000 went up significantly from 6,426 in 1994 to 15,083 in 2000, while the median income of persons dropped to \$1,489 in 2000 compared with \$2,637 in 1994.

21. The PSRP also had some negative gender specific impacts. The increase in women's role in subsistence production and predominance of women in private sector employment is largely in unpaid or low-wage work. Subsistence production tends to be a low status activity, with the exception of some villages on Yap. Though private sector development did not take place as envisaged, it became the major source of employment for female workers, and their share to total female employment increased from 52% in 1994 to 57% in 2000. The median income for female workers decreased by more than half, from \$1,910 in 1994 to \$918 in 2000, due to the concentration of females in low-income occupations.

#### **E. Impacts on Education**

22. Enrollment figures dropped from 34,582 in 1994 to 32,100 in 2000. Likewise, the gross enrollment ratio for elementary and high school levels decreased in 2000 compared with 1994 figures. The decline in gross enrollment ratio was much more substantial in high school level, from 81% to 72%. One possible reason for the decline was that quite a number of school age population sought employment (probably to augment family income) instead of attending schools. The labor force participation rate for persons aged 15 to 19 increased from 18% in 1994 to 33% in 2000.

23. An important socioeconomic impact of the reduction in personnel and other cost reduction measures was the negative consequence on service quality in public education. This is likely to be a combined effect of downsizing, cost cutting, and migration. At the elementary level, results of the National Standardized Test<sup>6</sup> in language and mathematics indicated a declining trend during the period 1997 to 2000. In addition, test results showed that elementary

<sup>5</sup> ADB. 1993. *Women in Development: Federated States of Micronesia*. Country Briefing Paper. Manila.

<sup>6</sup> A standardized testing program in language and mathematics for grades six, eight, and ten conducted by the National Department of Education to evaluate the effectiveness of the FSM's National Curriculum Minimum Standards.

students barely passed the tests and obtained the lowest score in areas where higher-level thinking skills were necessary. Negative impacts were also discernable at the secondary level. Based on the annual entrance test administered by the College of Micronesia, there has always been a significant difference in the passing rates between students of public and private schools, but the disparity was wider during the PSRP period. Of the five public schools in the FSM, Bailey Olter High School in Pohnpei had the highest average passing rate of 67% for the period 1996-2003 while Chuuk High School had the lowest average, 12%.

## **F. Conclusion**

24. Substantial migration and substantially increased subsistence production helped alleviate the adverse impact of downsizing in the public sector. In addition, the limited employment opportunities in the public sector were compensated for by the growth of wholesale and retail trade industry. It is possible that increased subsistence food and small-scale market production will have positive effects on public health. This is because there is a high prevalence of diabetes in the FSM associated with the consumption of imported processed food.

25. The less successful projected outcomes of the PSRP were not predicted because there was insufficient social analysis of historical structural socioeconomic and cultural conditions. Such analysis would have taken greater account of the 30 years of welfare-driven public policies. A deeper analysis might have suggested less optimistic predictions concerning private sector growth and indicated the more likely outcome of increased emigration. This consideration may have directed attention to the importance of education and human resource development as a mitigating strategy.

26. Based on evidence from other Pacific island developing member countries in similar situations,<sup>7</sup> tightening of the labor market is unlikely to lead to significantly increased domestic production and entrepreneurial activity, but very likely to increase migration, thus stimulating the growth of a remittance economy, with continued high levels of import dependence and low domestic productivity. Recognition of the high probability of this trend would have suggested the need to give high priority to the improvement of basic education, with the aim of improving the employment prospects of migrants and their capacity to obtain employment and remit support to relatives in the FSM. Instead, one result of the reforms appears to have been the further decline in the quality of public education.

27. Declining US budgetary support to the FSM may only result ultimately in a shift of costs from aid budgets to welfare budgets. Poorly educated and unemployable people in the FSM are exercising their option to move to the US and its territories. Accordingly, the state and federal governments should be encouraged to consider how their development policies could optimize the benefits of current migration trends. Trends over the past decade indicate that the FSM is likely to develop an economy in which migration and remittances become significant forces in maintaining low population growth and reasonable levels of social welfare. Human resource development is an investment that will pay dividends by enabling migrants to be accepted and obtain employment abroad, as well as promoting national development.

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<sup>7</sup> Schoeffel, Penelope. 1996. *Sociocultural Issues and Economic Development in the Pacific Islands*. Chapter 1. Asian Development Bank, Manila.

**Selected Social and Economic Indicators**  
1994 and 2000

Indicator	1994		2000	
	Number	% of Total	Number	% of Total
Population				
Resident Population	105,506		107,008	
Average Growth Rate (%)	2		0	
% Females	49		49	
Estimated Number of Migrants (Guam, CNMI, US)	10,565		25,539	
Percent of Total Population (Resident+Migrants)	9		19	
Health				
Fertility Rate				
All Women	5		4	
Women in Labor Force	3		3	
Crude Birth Rate (per 1,000)	31		28	
Infant Mortality Rate (per 1,000)	46		40	
Life Expectancy	65		67	
Education				
Total Enrollment	34,582	100	32,100	100
Pre-School	1,961	6	1,764	5
Elementary	22,459	65	20,885	65
High School	8,701	25	8,070	25
College	1,461	4	1,381	4
Gross Enrollment Ratio <sup>a</sup>				
Elementary	94		92	
Males	94		92	
Females	94		93	
High School	81		72	
Males	78		68	
Females	85		77	
Literacy Rate (%)	94		92	
Labor Force				
Potential Labor Force (Persons 15+ years)	59,573		63,836	
Males	30,127	51	31,821	50
Females	29,446	49	32,015	50
Labor Force	25,972		37,414	
Males	17,098	66	21,376	57
Females	8,874	34	16,038	43
Total Labor Force Participation Rate (%)	44		59	
Labor Force Participation Rate of Females (%)	30		50	
Labor Force Participation Rate of Age Group 15-19 (%)	18		33	
Employed	21,756	84	29,175	78
Unemployed	4,216	16	8,239	22
Employed	21,756	100	29,175	100
Formal Work	14,381	66	13,959	48
Agriculture and Fishing	7,375	34	15,216	52
Pure Subsistence	5,874	27	10,624	36
Market-Oriented Subsistence	1,501	7	4,592	16

<sup>a</sup> Defined as the ratio of primary level enrollment (enrollment in grades 1 to 8) to the population aged 6 to 13 years; and for high school—enrollment grades 9 to 12 to the population aged 14 to 17.

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Indicator	1994		2000	
	Number	% of Total	Number	% of Total
Formal Work Force (Number of Employees)	14,381	100	13,959	100
Public Administration	3,868	27	3,352	24
Education	2,825	20	2,785	20
Wholesale and Retail Trade	1,084	8	1,855	13
Health	716	5	732	5
Agriculture, Forestry, Fishing, and Quarrying	922	6	443	3
Construction	859	6	781	6
Gas, Electricity, and Water Supply	240	2	360	3
Transport and Communication	616	4	806	6
Manufacturing	316	2	721	5
Hotels, Restaurants, and Bars	610	4	685	5
Financial Intermediation	234	2	177	1
Business, Computer Activities, and Real Estate	276	2	549	4
Other Service Activities	1,815	13	713	5
Public Sector	8,025	56	7,426	53
Private Sector	6,356	44	6,533	47
Gender				
Males	10,016	100	9,343	100
Public Sector	5,919	59	5,213	56
Private Sector	4,097	41	4,130	44
Females	4,365	100	4,616	100
Public Sector	2,104	48	1,985	43
Private Sector	2,261	52	2,631	57
Income				
Number of Persons (15+ years) with Income	20,924		34,198	
Percent of Potential Labor Force	35		54	
Percent of Females with Income	36		47	
Median Income (\$)				
All Persons with Income	2,637		1,489	
Males	3,050		2,044	
Females	1,910		918	
Income Levels				
Less than \$1,000	6,426	31	15,083	44
\$1,000-\$4,999	8,256	39	11,767	34
\$5,000-\$9,999	3,785	18	4,479	13
\$10,000-\$20,000	1,780	9	1,992	6
Over \$20,000	677	3	877	3
Source of Income				
Total Number of Recipients <sup>b</sup>	25,073	100	44,990	100
Wages and Salaries	14,825	59	14,818	33
Profit from Business and Farm	2,098	8	7,389	16
Interest and Dividends	680	3	787	2
Social Security and Government Benefits	1,986	8	2,437	5
Remittances (within and outside FSM)	5,151	21	18,100	40
Other Income	333	1	1,459	3

CNMI = Commonwealth of the Northern Mariana Islands, FSM = Federated States of Micronesia, US = United States.

<sup>b</sup> Because many individuals received income from multiple sources, the number of recipients is greater than the number of persons with income.

Sources: 1994 and 2000 National Census Reports; 1999 Statistical Yearbook US Census Bureau.