Federated States of Micronesia: Private Sector Development Program
Performance Evaluation Report
December 2014

Federated States of Micronesia: Private Sector Development Program

This document is being disclosed to the public in accordance with ADB’s Public Communications Policy 2011.
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., FY2000 ends on 30 September FY2000.

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

<table>
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<tr>
<th>Director General</th>
<th>V. Thomas, Independent Evaluation Department</th>
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<tr>
<td>Director</td>
<td>B. Finlayson (since May 2014), H. Hettige, Independent Evaluation Division 2, Independent Evaluation Department</td>
</tr>
<tr>
<td>Team leader</td>
<td>Henrike Feig, Lead Evaluation Specialist, (since May 2014), Ma. Juanda Dimayuga, Senior Evaluation Officer, Independent Evaluation Department</td>
</tr>
<tr>
<td>Team member</td>
<td>Irene Garganta (since May 2014), J. Mendez-Santos, Senior Evaluation Assistant, Independent Evaluation Department</td>
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In preparing any evaluation report, or by making any designation of or reference to a particular territory or geographic area in this document, the Independent Evaluation Department does not intend to make any judgment as to the legal or other status of any territory or area.

The guidelines formally adopted by the Independent Evaluation Department (IED) on avoiding conflict of interest in its independent evaluations were observed in the preparation of this report. To the knowledge of the management of IED, there were no conflicts of interest of the persons preparing, reviewing, or approving this report.
Abbreviations

ADB – Asian Development Bank
CTF – Compact Trust Fund
FIAS – Foreign Investment Advisory Service
FSM – Federated States of Micronesia
FSMDB – FSM Development Bank
GDP – gross domestic product
IMF – International Monetary Fund
PCR – program completion report
PIU – program implementation unit
PPTA – program preparatory technical assistance
PSDP – Private Sector Development Program
PSE – public sector enterprise
PSRP – Public Sector Reform Program
RRP – report and recommendation of the President
SBDC – small business development center
TA – technical assistance
USA – United States of America

Currency Equivalents

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

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The team would like to thank ADB staff, as well as national and state government officials and other stakeholders in the Federated States of Micronesia who were interviewed for contributing their time and inputs.
Basic Data

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<tr>
<th>Key Project Data ($ million)</th>
<th>As per ADB Loan Documents</th>
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<td>First disbursement</td>
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<td>Loan closing</td>
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<td></td>
<td>1874: 31 Aug 2006</td>
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<td></td>
<td>1874: 4.35</td>
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Borrower: Federated States of Micronesia
Executing Agency: Department of Finance and Administration

Mission Data

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ADB = Asian Development Bank.
Executive Summary

Background

The Federated States of Micronesia (FSM) is a small island country, spreading across the four states of Chuuk, Kosrae, Pohnpei, and Yap, each with its executive and legislative bodies. FSM’s close ties with the United States of America (USA) through the Compact of Free Association and the high level of external transfers under the Compact place the country in a unique situation. The country has a disproportionally large public sector and a small productive base.

The national and state governments implemented the Public Sector Reform Program (PSRP) during FY1997–FY1999 with support from the Asian Development Bank (ADB). Although the PSRP achieved government downsizing, the economy contracted with little changes in the balance of economic activity between the public and private sectors. In response, the FSM government refocused its development policy agenda from public sector reforms to reforms creating an environment conducive to private sector development. Its earlier involvement in the PSRP, changes in government policy, and the availability of relevant diagnostic studies provided a compelling basis for ADB to support a program for private sector development in the FSM.

ADB approved the Private Sector Development Program (PSDP) on 12 December 2001. The PSDP aimed to improve economic, legal, and factor market conditions for private sector development. It comprised a policy loan and a project loan to support policy reforms and institutional development at the national and state levels.

ADB released the first tranche of the policy loan in two phases on 31 July 2003 and 30 July 2004. At the time of second tranche release, ADB considered that only the FSM national and Kosrae state governments substantially met loan conditions. On this basis, ADB released part of the second tranche funds and closed the policy loan on 7 February 2007, which was 2 years later than planned. Implementation of the project loan was also delayed due to slow progress made in procurement and civil works across the states. It was closed on 9 September 2009, delayed by 31 months compared with the original target. ADB disbursed 71% and 83%, respectively, of the total approved policy and project loan amounts.

The policy loan has produced mixed outputs: (i) the fiscal situation gradually improved during the program period although not due to related program conditionality; (ii) the Compact Trust Fund was launched but is unlikely to generate sufficient returns to replace the expiring Compact grants in FY2023; (iii) the government’s external debt management has been sound; (iv) wages in the public sector have remained significantly higher than in the private sector; (v) public sector enterprise (PSE) reforms have progressed only slowly and the PSE share in GDP actually increased while the share of private enterprises declined; (vi) appropriate land lease legislation was approved in Kosrae and Yap and a new mortgage law was enacted in Kosrae, but not in the other states; and (vii) foreign investment laws and regulations were improved, but their harmonization across the five jurisdictions has lagged behind; and while the approved legislation on secured transactions is largely in line with good
practices, the new bankruptcy regime is unlikely to be effective without further judiciary improvements.

Achievement of project loan outputs has also been mixed: (i) A nationwide secured transaction registry has operated successfully since 2006, as evidenced by continuously increasing numbers of registrations and searches. (ii) Physical facilities for state land administration and management were upgraded and skills improved, but the recommended land administration management information system was not operational in any state land offices and the vault built for the Pohnpei Court for Land Tenure did not meet the envisaged quality standards. (iii) Capacity development efforts for the FSM Development Bank led to improvement in its financial performance, but not to the envisaged expansion of small and medium enterprise lending and financing in outer islands. Moreover, the recommended information system could not be operationalized. (iv) Upgraded and restructured small business development centers in three states enhanced training and service delivery while the remaining one in Pohnpei did not improve its service delivery and was not operational at the time of evaluation. Meanwhile, the planned labor market information system was not established.

Performance Assessment

Relevance. The program is rated relevant in that the program’s targeted results were consistent with the national government’s development priorities and needs, as well as ADB’s country strategy at the time of approval. This remained the case at the time of evaluation. However, this evaluation also notes (i) insufficient buy-in for the reform program at state level; (ii) overambitious design in terms of program time frame and scope despite limited institutional capacity; (iii) inadequate resource allocations for program implementation support; (iv) issues related to the selection and formulation of a number of policy actions; and (v) some flaws in the design and monitoring framework, in particular a lack of baselines and monitorable performance targets.

Effectiveness. The program is rated less than effective, as many of the underlying project outputs were not fully attained in the first place or did not translate into envisaged program outcomes. Achievement of design and monitoring framework program outcomes could be substantiated only in part, as a number of performance targets were not sufficiently defined, baseline indicators were generally absent, and relevant data were not collected or made available to the evaluators. For example, it is unclear whether investor confidence or enterprise performance improved because envisaged enterprise surveys were not conducted and reliable data on the level of private investment and enterprise performance were unavailable. Economic conditions have moderately strengthened through improvements in fiscal and debt management practices and establishment of the Compact Trust Fund. Approved legislation on secured transactions improved the pertinent Doing Business indicator (as reported by the World Bank) related to private enterprise access to credit, whereas approved bankruptcy legislation has yet to result in improved recovery rates for creditors, which is considered by the Doing Business indicator related to resolving insolvencies. Relevant data to assess whether approved foreign investment or land lease legislation translated into increases in foreign investment or the use of land for commercial purposes was not available. Given the continuing unresolved legal, cultural, and political issues surrounding private land ownership in most states, it appears that program capacity enhancement efforts for state land administrations have not significantly improved the availability of land for commercial purposes outside Kosrae. While establishment of the secured transaction system reportedly facilitated access to (mostly consumer) finance
by those with movable collateral, the absence of reliable credit information, limited credit evaluation skills, and remaining issues surrounding the use of land as collateral continue to limit enterprise access to commercial bank loans. The program helped strengthen the financial sustainability of the FSM Development Bank and improved the provision of business training and advisory services in 3 of the 4 states. Nevertheless, related outcomes in terms of business formation and performance cannot be reliably assessed in the absence of relevant data.

**Efficiency.** The program is rated *less than efficient* in view of significant delays in implementing both the policy loan and the project loan and some evidence of uneconomic use of resources (particularly IT-related project components). Program documents and feedback from relevant evaluation informants suggest that only part of the counterpart funds under the policy loan were actually used to promote private sector development.

**Sustainability.** The program is rated *less than likely sustainable*. The FSM government continues to face a series of challenges in building nationwide consensus on necessary public finance reforms, thereby posing high fiscal sustainability risks. Some of the program implementation agencies presently face severe resource constraints and others would also be affected by any reductions in Compact funding in coming years. Moreover, some of the supported government agencies lack the commitment and results-orientation required for improving institutional performance and service delivery, which is critical to building and maintaining public support for efforts to strengthen the business environment.

**Impact.** Program impact is rated *moderate*. The program has not been transformational in changing the basic economic structure and the relative roles of the private and public sectors in economic development. The economy remains dominated by the large public sector (accounting for nearly 40% of gross domestic product [GDP]) while the private sector’s share in GDP decreased slightly. In real terms, the level of private sector output actually declined during the program period. Contrary to what was anticipated during the program’s design, the private sector did not absorb retrenched public sector employees. Although the overall share of private sector employment in total formal employment for the country increased slightly, the numbers of private sector employees declined. Kosrae, which largely implemented the reform agenda promoted under the program, temporarily experienced an increase in private sector output, both in absolute terms and as a share of overall GDP. For the other states, there was no clear link between program reform efforts and private sector growth.

On the basis of this evaluation, the program is rated *less than successful*.

**Issues and Lessons**

The major outstanding issues of the program are the following:

(i) **Fiscal consolidation through cuts in current expenditures will not be sufficient for achieving budgetary self-sufficiency by FY2023.** These need to be accompanied by structural reforms that can enhance the efficiency and effectiveness of public sector management and support private sector development, including (a) increased private sector involvement in the provision of public services, (b) introduction of results-based management approaches for government institutions and related incentive systems, and (c) improvements in interdepartmental
and intergovernment coordination (i.e., between national and state governments).

(ii) **The wage differential between the public and private sectors, which has been narrowing in the post-program period, remains significant.** The experience of comparable countries in the Pacific region in addressing this issue while avoiding institutional capacity problems in the public sector and outward migration should be studied.

(iii) **A mechanism to ensure rule-based, fair competition is lacking.** The feasibility of adapting the model regulatory and policy framework developed for the Pacific Island Forum and establishing an effective enforcement mechanism at the national or regional level should be assessed.

(iv) **Limited access to land and finance still constrains business development.** The land issue in the FSM is intricately connected to people’s perception of heritage and community. Thus, it needs to be tackled with a long-term perspective and through widespread public engagement to generate sufficient political support for the commercial use of land. The creation of an adequate legal basis for land ownership, transfer, and registration would facilitate broader acceptance of immovable assets as collateral, which in turn will enhance access to finance, as would the availability of reliable credit information to support credit decisions. The efficiency and effectiveness of contractual enforcement and bankruptcy processes also need to be improved, and there is scope to further enhance implementation of the new secured transactions framework.

(v) **Private sector development strategies are lacking.** In addition to skills development, the government identified agriculture, fisheries, tourism, trade, and renewable energy as priority areas for development. These appear to have good commercial potential and are private sector-based. The FSM government together with interested state governments and the private sector should devise strategies that identify and address general as well as industry-specific legal, regulatory, policy, infrastructure, skills, and institutional constraints upon developing these sectors and attracting domestic and foreign investment. While the national-level strategy should focus on areas of mutual interest that are best addressed at the national government level, to ensure adequate buy-in there is also need for state-based action plans that reflect each state’s private sector development priorities. Compact private sector grants could be linked to implementation of such strategies.

The evaluation team identifies the following lessons:

(i) **Ascertaining legislative support at both the national and state levels is an important aspect of determining project readiness in the FSM.**

(ii) **Policy actions must be formulated in a manner that does not leave room for ambiguity or interpretation of supported policy principles.**

(iii) **A design and monitoring framework can be an effective instrument to attain results only if it is properly shared with implementing agencies and it provides clear performance targets with appropriate timelines, monitoring mechanisms, and baseline data.**

(iv) **Consider targeting support for reform initiatives in FSM at individual states, as reforms that require coordinated policy actions among states are difficult to implement given the geographically dispersed nature**
and different policy interests of the four FMS states, which have significant autonomy.

(v) Program implementation arrangements in the FSM need to recognize the limited authority of a program implementation unit at the national level over state administrations.

(vi) IT-related project components need extra attention from ADB in small, remote countries with low-capacity.

(vii) Public enterprise reform in the FSM requires creative approaches to involving the private sector in the management of public assets given limited private sector capacity and interest.
CHAPTER 1

Introduction

A. Evaluation Purpose and Process

1. The Private Sector Development Program (PSDP), approved by the Asian Development Bank (ADB) in 2001, was to assist the Government of the Federated States of Micronesia (FSM) in creating an environment conducive to private sector development and improving factor markets' conditions and performance. The program comprised a policy loan (Loan 1873) and a project loan (Loan 1874). The two loans were to support activities at both national and state levels.

2. An independent evaluation of the program was included in the 2013 work program of the Independent Evaluation Department to provide inputs to a broader thematic evaluation on ADB support to the Pacific Region and its microstates in 2015. The timing of this report, more than 6 years after the policy loan’s closing and nearly 4 years after the project loan’s closing, allows sufficient time for the outputs and outcomes to be independently assessed and the impacts to be examined. Following the Independent Evaluation Department’s evaluation guidelines, the program performance evaluation report assesses the performance of the program and highlights lessons.

3. The December 2010 program completion report (PCR) rated the program successful, based on its individual criterion assessments of relevant, effective, less efficient, and likely sustainable. The PCR provided a candid assessment on the program’s implementation and outputs. Its assessment of program outcomes was constrained, however, by limited availability of performance indicators, and thus its favorable overall success rating was not well supported by evidence.

4. A review of the report and recommendation of the President (RRP), PCR, and other documents available at ADB headquarters was followed by an independent evaluation mission to the FSM to consult and acquire information from the national and state governments, relevant government agencies, financial institutions, business communities, and other stakeholders. The draft program performance evaluation report was shared with the Pacific Department, the executing agency, and the concerned implementing agencies for feedback and comments.

B. Program Objectives

5. According to the program framework in the RRP, the program’s expected impact was to “increase sustainable economic growth in the FSM through an increased

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contribution of the private sector.” The program outcomes were to (i) develop a sound economic and legal environment conducive to private sector development; and (ii) improve access to and competitiveness of land, labor, and capital resources to increase business prospects and performance. The program outputs were classified into (i) continued economic and legal reforms, and (ii) improved public services to support private sector development. The policy loan was to support the former, and the project loan was to support the latter as well as to strengthen the capacity for coordinating and monitoring the program.

6. The program framework shows the impact, outcomes, outputs, activities, and performance targets (Linked Document A). The achievements of both performance targets are shown in Linked Document B. The policy matrix comprised 26 policy measures, of which 10 measures (or actions) were to be implemented prior to second tranche release and 8 measures (or targets) by the end of the program period. Eighteen of these 26 policy measures were to maintain economic and public sector reforms and the remaining 8 measures were to improve the legal environment for private sector development. All the 10 second tranche actions were applicable to the four states, while 8 of the 10 such actions were applicable also to the national government. The status of the policy measures is shown in Linked Document C.

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4 The program goal stated in both the RRP and PCR is equated with the program impact, the program objective is equated with the program outcome, and the program framework is equated with the design and monitoring framework.
CHAPTER 2

Design and Implementation

A. Rationale

7. The FSM is a small island country, spreading across the four states of Chuuk, Kosrae, Pohnpei, and Yap, each with its own executive and legislative bodies. Its political and economic ties with the United States of America (USA) through the Compact of Free Association and the high level of external transfers under the Compact place the country in a unique situation. The country has a disproportionally large public sector and a small productive economic base. To tackle these issues, in fiscal year (FY) 1997 to FY1999, the national and state governments implemented the Public Sector Reform Program (PSRP), supported by ADB. Although the PSRP achieved downsizing of the national and state governments, this downsizing was only weakly related to strategic restructuring of government operations. Moreover, the private sector remained stagnant and did not create enough jobs for those who left government employment. Therefore, soon after the PSRP’s completion, the governments faced pressure to rehire staff. That pressure was compounded by a reduction in Compact cash grants during FY1997–FY2001.

8. To regain reform momentum and address the emerging issues, the second FSM Economic Summit was held in September 1999. This summit underscored the need to refocus the government development policy from concentration on public sector reforms to broader reforms to create an environment conducive to private sector development. Diagnostic studies conducted prior to the summit under ADB technical assistance (TA) and other initiatives had identified impediments to private sector development including (i) weak foreign investment laws and regulations, (ii) weak land administration and management and difficulties in using and leasing land, (iii) significant government involvement in commercial activities, (iv) limited access to finance due to the weak collateral framework, and (v) lack of skilled labor. The earlier involvement in the PSRP, the refocused government policy, and the sound diagnostic studies created a compelling basis for ADB to support a program promoting private sector development in the FSM.

5 The original Compact covering the period FY1987-FY2001 allowed for annual cash grants averaging $97.9 million for FY1987–FY1991, $91.1 million for FY1992-FY1996, and $79.2 million for FY1997–FY2001. The “two-steps down” of the grant amount after the 5th and 10th years was intended to strengthen budgetary self-reliance, but this aim was not achieved. The original Compact provided for assistance for a 2-year transitional period following its expiration in September 2001. This assistance, the so-called “bump-up fund,” was at the average level for the first 15 years, or $88 million.

6 Loan 1520-FSM: Public Sector Reform Program, for $18.0 million, approved on 29 April 1997 and completed on 31 December 1999.

7 TA 2758-FSM: Improved Economic Use of Land, for $550,000, approved on 4 February 1997; and TA 3201-FSM: Privatization of Public Enterprises and Corporate Governance, for $450,000 approved on 31 March 2001.

8 Such initiatives included the United Nations Development Programme-assisted Micronesian Entrepreneur Development Program; investor surveys conducted by the Forum Secretariat in 1998; foreign investment reviews conducted by the Foreign Investment Advisory Service in 1997 and 1999; and the FSM Banking and Investment Symposium held in Palikir, Pohnpei in 1998.
B. Formulation

9. Soon after the second National Summit, at the request of the FSM government, ADB approved a program preparatory TA (PPTA) to assist the government in formulating the program. The FSM government presented its intention to adopt a policy framework developed through the PPTA at the fourth Consultative Group Meeting in February 2000. Feedback from the PPTA team leader indicates that the policy framework had reflected adequate stakeholder consultations and governments’ ownership in reforms. This view was validated by the key government official who had closely worked with the PPTA team. The PPTA performance could not be further assessed because the PPTA related documents are not available in ADB at the time of evaluation.

10. Following completion of the PPTA, an ADB loan fact-finding mission was fielded during May–June 2000 and followed up by an appraisal mission in September 2000. The missions visited all four FSM states to confirm the policy matrix and the project plan developed under the PPTA. The aide mémoires of these missions indicated that the program content had been largely agreed at PPTA stage, and therefore no major issues were raised during loan processing. The appraisal mission expected ADB Board approval of the program in April 2001. Passage of the PSDP through the FSM Congress took a year, however, and it was eventually passed in November 2001. ADB approved the program on 12 December 2001 and the loan agreements were signed on 24 January 2002. The PPTA team leader pointed out that the reform momentum might have been lost during this unexpected interval between appraisal and loan approval.

C. Cost, Financing, and Executing Arrangements

1. Policy Loan

11. Costs and financing. ADB approved a policy loan of SDR3.912 million ($5 million equivalent at the time of approval) based on the estimated adjustment costs, the scope and importance of reforms, and the state of public finances. The program’s adjustment costs were estimated to be about $5 million over 3 years at the time of loan approval. ADB actually disbursed $3.553 million under the policy loan.

12. Use of loan proceeds and counterpart funds. The loan proceeds were to be withdrawn from the program loan account for a broad range of imports, subject to a negative list. The counterpart funds to be generated from the loan proceeds were to be used by the national and participating state governments to support their activities consistent with the program objectives. A portion of the counterpart funds were to be allocated from the national government to the four state governments upon compliance with the conditions specified for each state in the policy matrix and under terms and procedures defined in the relending agreements. The planned and actual costs and financing. ADB approved a policy loan of SDR3.912 million ($5 million equivalent at the time of approval) based on the estimated adjustment costs, the scope and importance of reforms, and the state of public finances. The program’s adjustment costs were estimated to be about $5 million over 3 years at the time of loan approval.11 ADB actually disbursed $3.553 million under the policy loan.12

11. The adjustment costs included a redundancy payment of $1.5 million, retraining costs of $2 million, and administrative and legal expenses of $1.5 million to be incurred as a result of public sector enterprise (PSE) reforms. It was anticipated that these costs would be partly offset by reduced subsidies to loss-making enterprises.

12. The loan maturity was 24 years, including a grace period of 8 years, with an interest rate of 1% per annum during the grace period and 1.5% per annum thereafter.
allocations of the counterpart funds of the policy loan are shown in Tables D.1 and D.2, Linked Document D. Differences were due to noncompliance with second tranche conditionality in three of the states. The counterpart funds were to be used for program-related expenditures and adjustment costs. The counterpart funds of the policy loan proceeds were actually used for (i) mainly private sector development purposes by the governments of the FSM, Pohnpei, and Yap; (ii) settlement of overdue debts to local vendors by the Chuuk state government; and (iii) a trust account directed to repayments of ADB’s PSRP loan by Kosrae state.

13. **Scheduling and trancheing.** The policy loan’s implementation period was envisaged to be 36 months. The loan of SDR3.912 million ($5 million equivalent at the time of approval) was to be disbursed in two equal tranches. The first tranche was to be made available upon loan effectiveness. The policy loan became effective on 24 April 2003, delayed by 1 year from the RRP estimate. Kosrae, the FSM, Pohnpei, and Yap were qualified to participate in policy loan transactions upon loan effectiveness, but Chuuk was ineligible until 22 June 2004 due to noncompliance with the program measure on the government wage bill for FY2003. Therefore, ADB released the first tranche in two phases: $1.85 million on 31 July 2003 and $0.65 million on 30 July 2004.

14. ADB released the second tranche of the policy loan on 7 February 2007, delayed by 2 years from the original target due to slow reform implementation. Considering the substantial progress made by the national and Kosrae state governments by that time, the ADB Board approved (i) a change in second tranche release conditions requiring that apart from the national government at least two states comply with respective policy conditionality, and (ii) release of the second tranche in the amount of SDR0.704 million ($1.053 million) based on the original allocation plan of the counterpart funds. The second tranche release coincided with the policy loan’s closing, also delayed by 2 years from the original target.

15. **Implementation arrangement.** The Department of Finance was the executing agency, responsible for loan withdrawals and for allocating and monitoring the use of counterpart funds. The Department of Economic Affairs was the implementing agency responsible for overall program implementation at the national level. The program implementation unit (PIU) was established within the Department of Economic Affairs to coordinate day-to-day activities. Each state governor’s office was designated as implementing agency at state level. A national steering committee was formed to monitor and coordinate program implementation. ADB approved small-scale TA in December 2004 to give technical advice and guidance to governments on key reform areas where little progress had been noted in the first 2 years of program implementation, in particular regarding public sector enterprise (PSE) reforms and legal reforms.

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13 The allocation plan reflected the revenue-sharing scheme between the national and state governments; the scope, cost, and importance of the policy reforms; and each government’s financial capability.

14 Execution and delivery of the relending agreements to the national government by at least two states together with legal opinions and legislative resolutions and establishment of the PIU within the national government were conditions precedent common to the policy loan and project loan.

15 The deadline for declaring loan effectiveness was extended three times, in May 2002, October 2002, and January 2003. Loan effectiveness was delayed because legislative authorization for the program in Chuuk and Pohnpei and finalization of the consulting contract for the PIU took longer than expected.

16. **Covenants.** The PCR indicated noncompliance with two administrative covenants requiring the government to submit to ADB (i) a report on the program execution upon loan closing, and (ii) certified copies of the audited accounts within 6 months after the date of ADB’s request, as well as partial compliance with record and document keeping related to the use of loan proceeds and the monitoring of program progress (Table E.1, Linked Document E). The PCR also reported the status of the 18 policy actions, including 10 second tranche release conditions, of which 3 that required passage of state legislation were deemed to have been complied with only in part, but it did not mention the status of the “end-of-program” targets indicated in the policy matrix and which should have been jointly reviewed by ADB and the FSM government.

2. **Project Loan**

17. **Costs and financing.** The actual total project costs of $9.983 million (against its estimate of $13.032 million) included the base costs and operating costs for (i) a secured transaction system, (ii) state land administration and management, (iii) FSM Development Bank (FSMDB), (iv) small business development centers (SBDCs), and (v) the PIU (Tables D.3 and D.4, Linked Document D). These components largely comprised the procurement of equipment and consulting services, with civil works being limited to the land administration and management and SBDCs components. ADB approved a project loan of SDR6.273 million ($8.017 million equivalent at the time of approval) from the Special Funds resources, of which it disbursed $6.647 million.\(^{17}\) The national and state governments contributed $3.336 million (33% of the actual total cost) from their own resources against the estimate of $5.015 million (39% of the estimated total cost).

18. **Scheduling and disbursement.** The project implementation period was envisaged as 4 years. The loan became effective on 24 April 2003 at the time the policy loan also became effective. Although consultant selection and contract negotiations progressed smoothly, project implementation was delayed due to the slower-than-expected pace of procurement and civil works. Disbursement remained behind targets especially during the first 2 years of implementation. The loan closing date was extended four times. Closing was on 9 September 2009, 78 months after loan effectiveness (against the scheduled period of 53 months).

19. **Implementation arrangement.** The implementation arrangement for the project loan was largely the same as for the policy loan (para. 15),\(^{18}\) except that the implementing agency in each state for the land administration and management component varied in line with the prevailing institutional setup.\(^{19}\) According to the PCR, (i) the PIU was inadequately resourced and did not receive adequate support from the national and state administrations;\(^{20}\) and (ii) because the national steering committee

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\(^{17}\) The loan maturity is 32 years, including a grace period of 8 years, with an interest rate of 1% per annum during the grace period and 1.5% per annum thereafter.

\(^{18}\) The legal component of the project loan was to be managed by the PIU but was effectively implemented by the FSM Attorney General’s Office, which managed the secured transaction component. The Department of Economic Affairs facilitated recruitment of the consultants for FSMDB and also coordinated the project inputs for the SBDCs (PCR, para. 22).

\(^{19}\) These were (i) the Land Tenure Court and the Department of Lands in Pohnpei, (ii) the Land Commission and the Division of Land Management of the Department of Commerce and Industry in Chuuk, (iii) the Land Court and the Division of Land Resources of the Department of Resource Management and Development in Yap, and (iv) the Land Commission (subsequently transformed into the Land Court) and the Survey and Mapping and Land Management Division of the Department of Agriculture in Kosrae.

\(^{20}\) Recruited for the first 3 years of program implementation, the international program manager was gradually phased out and national counterpart managers were trained to take over. However, the
was not functional, coordination between the national and state administrations and among the various state administrations was deficient.

20. **Covenants.** The PCR indicated noncompliance with the covenant requiring the national government to submit to ADB a project completion report. The PCR also reported the status of the 19 other key loan covenants, of which 5 were complied with only in part (Table E.2, Linked Document E).\(^{21}\)

### D. Consultants, Procurement, and Construction

21. **Secured transactions registry.** In addition to an international secured transaction specialist as per original plan, a locally based international lawyer was contracted for this component. A filing office for secured transactions, operated entirely on the internet (rather than at the state land offices as originally envisaged) became operational in October 2006 with no major delays. The evaluation team could obtain no direct feedback from the government department concerned on performance of the consultants or procured equipment.

22. **Land administration and management.** The consultants for land administration and management were deployed in early February 2005.\(^{22}\) Program-related documents and feedback obtained from implementing agencies gave little information on consultant performance. The PCR reports a reprioritization of consulting tasks in response to government requests and implementation issues. Land valuation support was brought forward. Assistance related to implementing land administration management information systems had to be refocused due to late procurement of equipment. Advisory services for advocating and supporting the passage of draft land legislation were increased. Civil works and procurement of equipment for land administration offices were completed by March 2007 in Kosrae and Pohnpei but were delayed in Chuuk and Yap due to design- and contractor-related issues for the building work.

23. **FSMDB.** As originally planned, a senior banking adviser and an information system specialist were contracted for the FSMDB. They were fielded in February and March 2004, respectively. FSMDB management appreciates the banking adviser’s inputs to the corporate plan and in-service training, although not all recommendations were accepted and adopted. The original information system specialist who had identified integrated loan and general ledger software requirements and helped assess potential software vendors was not available to supervise the implementation phase.\(^{23}\) His replacement was recruited on the basis of his regional experience rather than

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\(^{21}\) These 5 covenants related to the establishment of a project steering committee and state coordinating committees, timely provision of project funds, establishment of a detailed project monitoring framework, and cost recovery for land administration services.

\(^{22}\) The team was to comprise (i) team leader, (ii) land registration specialist, (iii) survey and mapping specialist, (iv) systems analyst and trainer, (v) valuation specialist, (vi) land use planning and legal information system specialist, and (vii) legal expert. The evaluation team could not verify if there was any deviation from this original plan.

\(^{23}\) The terms of reference for the banking IT consultant had envisaged adaptation of FSMDB’s existing banking software. The consultant found this was not the best way forward as the software was not integrated across bank functions, posed security risks, and could not be adequately supported by the vendor. It was thus decided to procure new software and help the bank supervise its implementation by the selected vendor. Given delays in procuring the software, the banking IT consultant was not available for the extension period.
technical expertise in banking software systems. This became problematic when the contracted vendor had more work than originally anticipated to adapt its software to FSMDB needs. The procured system could not be operationalized due to unresolved problems with functionality of the software.

24. **SBDCs.** The original plan was to hire consulting teams for SBDCs in all the states. The SBDCs in Chuuk, Kosrae, and Yap did not require advisory services under the program, however, as they were being supported under the Pacific Islands Small Business Development Center network at the University of Guam. Not much information is available on the consulting services provided to the Pohnpei SBDC. Civil works for SBDC buildings in the four states were significantly delayed due to a series of implementation issues.25

**E. Outputs**

1. **Policy Loan**

   a. **Maintenance of Balanced Budgets**

25. The rather unorthodox definition of a “balanced budget” provided under the PSDP included current revenues and capital grants on the revenue side but excluded capital expenditures in calculating fiscal expenditures.26 Although pertinent program conditionality was complied with during FY2004–FY2009, this was not necessarily synonymous with significantly improving fiscal discipline, as it allowed current balances to be negative. It also was not consistent with the long-term goal of achieving budgetary self-sufficiency, as that requires overall fiscal surpluses. However, increases in captive corporate tax revenues and fishing licensing fees, as well as reductions in the number of public servants in Chuuk and Kosrae, did help gradually to improve the overall fiscal situation at the national and state levels over the program period and beyond. Overall annual fiscal deficits of the FSM national and state governments mostly declined from FY2004–FY2007. During FY2008–FY2013, moreover, the national government as well as Chuuk and Kosrae did manage to record modest surpluses (Appendix 2, Table A2.1). At 10% to 11% of GDP, however, the country’s tax revenues remain low compared to those of its Pacific peers, as implementation of a tax reform package including the introduction of value-added and net profits taxes and the creation of a unified revenue authority has been delayed due to resistance at the state level. Moreover, the International Monetary Fund (IMF) during its 2013 staff visit concluded that the operational efficiency of current and capital expenditures and the country’s capacity for fiscal management require strengthening.27

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24 The PSDP originally planned for the construction of new buildings for Chuuk, Kosrae, and Pohnpei SBDCs on the state campuses of the College of Micronesia-FSM and renovation of the Yap SBDC building (not located at the college campus). Pohnpei and Yap followed the original plans, but Chuuk and Kosrae chose locations not on the college campus.

25 The issues included (i) delayed initial design work and staff shortage in the Department of Planning in Chuuk, (ii) delayed feasibility study and disputes between the Department of Public Works and the contractor for civil works in Yap, and (iii) temporary suspension of civil works in 2006 due to a change in the facility design in Pohnpei.

26 As such, the “balanced budget” as defined under PSDP does not correspond to either current or overall fiscal balances.

b. Maintenance of Government Payroll Levels and Reductions of Public to Private Sector Wage Differentials

26. Containing public sector wages and salaries has been considered crucial to the success of fiscal consolidation efforts and improved private sector competitiveness. The PSDP policy matrix set ceilings for wage bills of the national and state governments during FY2002–FY2004. At the time of loan effectiveness in April 2003, all states but Chuuk held their FY2003 wage bills below the respective ceilings. The Chuuk state government subsequently adjusted the FY2003 wage bill, thereby enabling it to participate in the program. ADB released the second PSDP tranche in February 2007 while considering that the FY2005 wage bills of all the governments were below the ceilings set for FY2004 wage bills. Despite some successful retrenchment efforts in a couple of states, on a consolidated basis, average annual expenditures for public wages and salaries grew much more from FY2004 to FY2008 than thereafter (Appendix 2, Table A2.2). This reflected an increase in the number of government employees, particularly in Pohnpei and Yap, but, more significantly, increases in salary levels for public sector employees during the program period.28

27. During FY2004–FY2012, average salary levels for national government employees rose by 2.9% per year on average, with significantly higher increases during the program period than afterwards.29 Average nominal wages for state employees in Chuuk and Yap grew faster than the FSM average of 1.4%, while average nominal wage levels for Pohnpei state government employees actually declined by 0.5%. Although public payroll expenditures have been contained in recent years, public wages, at 20.9% of the country’s GDP, are still high compared to other countries in the Pacific region. At the same time, nominal FSM private sector wages increased on average by 3.4% (Appendix 2, Table A2.3). As a result, the wage differential between private sector and government wages narrowed slightly, and particularly in the post-program period. The same applies to the nominal wage differential between private sector and public sector enterprises, which rose during the program period but moved lower thereafter. Nevertheless, national government employees in 2013 were still earning on average 3.3 times more and PSE employees 2.6 times more than were private sector employees. The overall public-private wage ratio remains very high by international standards. Although public wage bills have stabilized in recent years, there is need to contain public wages going forward, and other countries in the Pacific region with lower ratios of public wages to GDP indicate there might be some scope for improving the efficiency of current expenditures in FSM without prompting further outward migration, although this remains a risk.

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28 While the PSRP had achieved 20% savings in average public payroll costs by FY1999, by FY2010 average public wage bills had reverted back to levels prevailing before the PSRP was initiated. Although the PSRP helped achieve a 16% reduction in public sector employment to levels that were largely maintained thereafter, earlier payroll savings were eroded by governments’ failure to contain public wage levels. (Graduate School USA, Pacific Islands Training Initiative. 2014. FSM Fiscal Year 2013 Economic Review [PreliminaryReport]. http://www.pitiviti.org/news/wpcontent/uploads/downloads/2014/08/FSM_EconPrelim_FY13.pdf).

29 The Pacific Regional Department informed the Independent Evaluation Department that at least the growth in the national government’s wage bill was mainly due to an increase in exceptional employees and contract workers outside the official pay structure to circumvent the strict control of nominal wages and the number of staff positions.
c. Sound Management of the Compact Trust Fund (CTF)

28. To ensure FSM’s budgetary self-reliance upon discontinuation of the Compact grants in 2023, Compact II agreements included establishment of the CTF as a key feature. The CTF has received initial contributions from the FSM national and state governments and scheduled annual transfers from Compact funds. It was valued at over $323 million (more than 90% of GDP) as of the end of September 2013.

29. During its initial years, performance of the CTF was affected by the following issues: (i) the FSM deposited its required $30 million contribution in October 2004 with a 1-year delay, leading to delay in the USA’s initial contribution of $16 million; and (ii) allocation of the deposited funds according to the asset classes identified in the FSM Investment Policy Statement did not occur until August 2006, 34 months into the Compact II period. Furthermore, average returns on invested funds of about 4% from the Fund’s inception in 2004 through FY 2012 were lower than anticipated. This was due only in part to the impact of the 2008-2009 global economic crisis, as the returns were also somewhat lower than those of a comparable market benchmark. The funds are managed by a reputable professional fund manager. The investment approach has shifted since 2012 from a passive index-driven approach to a more proactive one with lower allocations for fixed income investments and a higher share of alternative investments. Although returns in recent years improved (reaching 15% in FY2012) as the result of a stronger performance of international capital markets, assuming net investment returns on the CTF assets of 6% per year through FY2023, the IMF projects a shortfall of $16 million (about 5% of GDP) between CTF investment returns and the volume of Compact grants they are to replace for the drawdown phase commencing in FY2024 (footnote 27). The budget would need to run a surplus in the coming years sufficient to maintain the real value of the Fund after FY2023, thereby requiring significant fiscal adjustments and structural reforms to promote private-sector growth.

d. Sound Management of External Debt

30. The FSM has maintained its external debt at a relatively low level, within 30% of GDP, since the end of FY2000. It had been as high as 54% of GDP as of FY1995’s end (Appendix 2, Table A2.4). Of the total external debt amounting to $90.3 million as of the end of FY2012, $56.3 million (62.3% of the total) is owed by the FSM national governments. The amended Compact of 2003, or Compact II, covering FY2004-FY2023, provides total funding of $92.7 million per year comprising grants, audit funds ($0.5 million), and trust fund contributions. Grants were $76.2 million during FY2004-FY2005, after which they declined by $0.8 million per year in nominal terms. Grants and trust fund contributions are indexed at the lesser of two-thirds the increase in the US GDP deflator or 5%.

31. The CTF was created to contribute to the FSM’s long-term budgetary self-reliance and to provide the FSM government with an ongoing source of revenue after FY2023. The original CTF concept envisaged a level of financial assets at end-FY2023 that would generate an investment income large enough to replace expiring Compact grants without significantly disrupting public services and eroding the value of the Fund. Then again, the amended Compacts and their subsidiary agreements contain no commitments regarding the level of the revenue that will be generated by the trust fund, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the FSM. Moreover, to reduce the size and immediacy of the fiscal adjustment required during the early period of amended Compact implementation, the initial starting level of annual Compact grants was increased. This was financed through corresponding decreases in initial CTF contributions and annual decrements. This resulted in a reduction of total U.S. contributions to the Fund by about 20% over the 20-year period compared to levels anticipated at CTF design. (Graduate School USA, Pacific Islands Training Initiative. 2013. FSM: Fiscal Year 2012 Economic Review. http://www.pitiviti.org/news/wp-content/uploads/downloads/2014/02/FSM_EconReview_FY12.pdf).
Debt service as a percentage of exports averaged about 9% during the program period and increased to an average of 12% during FY2010–FY2012 (or 17% if debt is adjusted for offsetting assets, which level is still low in comparison with other developing member countries).

e. Progress in Public Sector Enterprise (PSE) Reforms

31. Much of the groundwork for the PSE reforms was conducted in 2000 under TA 3201-FSM (footnote 7), which also helped familiarize decision-makers with basic concepts of and approaches to public private partnerships. The key TA outputs were (i) a detailed analysis of 10 pilot PSEs intended for transformation, which reflected the governments’ priorities; and (ii) model 5-year master plans for PSE reforms. While ADB at the time of second tranche release found that the master plans had been submitted to each legislature, the evaluation team could obtain no copies of these plans or any meaningful feedback on their status from the national and state governments. The PSE reforms carried out by all the governments except Chuuk prior to the second tranche can be summarized as follows: (i) the national government transferred the water system for the capital to the Pohnpei Utilities Corporation, (ii) the Kosrae government outsourced catering for the early childhood program and the hospital, (iii) Pohnpei’s Economic Development Authority sold three fishing vessels, and (iv) the FSM Telecommunications Corporation took over the television service from the Yap state government. Little information is available, however, on related cost savings or improvements in service delivery as a result of these measures. The outsourcing of catering services in Kosrae ultimately failed.

32. Further restructuring of public sector commercial activities has progressed slowly after the PSDP implementation, albeit with some tangible achievements. None of the governments has taken any comprehensive approach to PSE reforms and a number of public enterprises, such as the National Fisheries Corporation as well as the Coconut Development Authority, are practically defunct, thus reducing the need for any further action. Then again, in 2008, the FSM national government established the FSM Petroleum Corporation, or Petro Corp, which took over the fuel storage and wholesale distribution facilities in Chuuk, Pohnpei, and Yap from Mobil Oil Micronesia (and subsequently also in Kosrae from its state-owned corporation). As a result, the public enterprise share in GDP grew from around 7% during FY2004–FY2008 to 10% at the end of FY2012.

32 For the six ADB loans (including the two PSDP loans), the FSM national government entered into financing agreements with the four states whereby a portion of the loan proceeds were relent under the same terms and under conditions of the corresponding ADB loans. The states in turn relent a portion of the loan proceeds to state utility corporations.

33 Based on the TA findings, the governments and ADB agreed to (i) broadly define PSEs in a way not to exclude 10 readily identifiable activities contained within national or state departments in addition to 26 formal public enterprises identified at the time of PSDP appraisal; and (ii) consider a variety of potential activities to constitute “reform” or “transformation,” including, among others, liquidation, divestiture, corporatization, commercialization, asset transfers, and outsourcing.

34 The selection criteria for the pilot PSEs included (i) importance to the FSM economy, (ii) commercial viability, (iii) value to the community, (iv) political sensitivity and climate, (v) the need to restructure prior to privatization, and (vi) the effect on unemployment (Consultant Report of TA3201-FSM, January 2001).

35 Program conditionality required that at least one PSE be transformed at each the national and state levels.

36 The National Fisheries Corporation has restructured its operations by liquidating 6 of 9 vessels; the Pohnpei Economic Development Authority was integrated with the State Division of Marine Resources and is administering leases of the dissolved Pohnpei Fisheries Corporation’s fish processing plants that are operated by a foreign-owned private company; the Chuuk state government leased out its ice-making plant to a private sector operator; and the Yap state government has outsourced hospital catering, laundry, and mortuary services.
f. **Long-term Land Lease Laws and Lease-backed Mortgage Laws**

33. PSDP sought to increase the commercial use of land and bank lending to the private sector by promoting improvements in the legal basis for land leases and mortgages in line with model legislation prepared under earlier ADB-funded advisory support (TA 2758-FSM, footnote 7). Legal changes were to be adopted by all states under second tranche conditionality. The two model laws and their defining features could not be further assessed because these TA outputs were not available within ADB at the time of evaluation, nor could compliance with their basic principles be independently ascertained, as these were not sufficiently described by ADB in any of the loan documents.

34. At the time of second tranche release, only Kosrae was deemed to have enacted both leasehold and mortgage legislation that largely followed the model acts. These laws are still in place. An evaluation informant (foreign investor) in Kosrae nevertheless recalls there being a somewhat easier—because more flexible—market environment without any ceiling for leasehold periods set by law prior to enactment of the Leasehold Act. One of the supported reform objectives according to the PSDP RRP was to lengthen land leasehold periods to reduce uncertainty for investors and financiers. The adopted Kosrae state act set the ceiling of the lease period at 55 years (renewable for another 55 years). While the model act envisaged a period of 99 years, leasehold periods in excess of 50 years are nevertheless considered adequate for most commercial purposes. By comparison, the ceiling for leasehold periods is set at 99 years in Chuuk and Yap, with Yap’s constitution prohibiting land leases over 50 years to foreigners. The Pohnpei constitution prohibits land leases in excess of 25 years unless otherwise provided by legislation, with the existing state act permitting commercial leases of up to 55 years and renewable up to 99 years. Apart from Kosrae, Yap was the only other state that improved its legal framework for land leases in line with the model law by passing required amendments to existing legislation in 2006.

35. While Chuuk state adopted a combined statute covering land leasing and lease-based mortgages in 2003, ADB judged this to be not in line with the model law provisions and to have several significant shortcomings reducing its effectiveness. Pohnpei state made no changes to its legal framework for land leases under PSDP. As of the time of evaluation, the Chuuk and Pohnpei state governments also do not intend to adopt mortgage legislation based on the model acts promoted under PSDP. In Yap, amendments to the law governing long-term leasing of land were made in 2006, but no amendment has been made to the existing Mortgage Act 1987 and the Yap state governor interviewed by the evaluation mission considered the establishment of a legal basis for land registration as a prerequisite for the active use of land leases and mortgages. In this light, the state government had submitted a bill on land registration and the establishment of a court for land tenure to the legislature in 2007. That bill had not been supported by the legislature, however, and it was under review for resubmission at the time of the evaluation mission. Existing mortgage statutes in Chuuk, Pohnpei, and Yap lack an efficient mechanism for nonjudicial foreclosure, redemption, and other procedures for commercial banks to take a security interest in property including land leasehold. Moreover, because foreign ownership of land in the

37 Lease terms are controlled exclusively at the state level.
38 According to a government official in Pohnpei, the state’s deed of trust law together with the existing mortgage law allow property to be used as collateral for construction loans.
39 Further assessment would be needed to judge if this act follows the 1999 model act.
FSM is forbidden, mortgages are generally not available to foreigners, although a leasehold interest may be used as security for a mortgage in some cases. Foreign investors perceive securing land leases to be difficult.

**g. Renewed Foreign Investment Laws and Regulations**

36. Until the late 1990s, the national government controlled foreign investment under the outdated law from the UN Trust Territory days. The FSM government requested the Foreign Investment Advisory Service (FIAS) to conduct a review with an aim to renew the related legislation and regulations. The FIAS recommendations set three goals: (i) decentralization, (ii) uniformity of structure across the states, and (iii) making the rules less restrictive and more transparent. The FSM and state governments selectively followed the FIAS recommendations in the late 1990s, resulting in the achievement of “decentralization” but not of the other goals.

37. The PSDP envisaged achievement of the remaining goals as reiterated by FIAS in its second proposals (FIAS II). The Kosrae, FSM, and Yap governments amended their foreign investment legislation and regulations modeled after FIAS II during the program period. While the Kosrae and FSM governments have maintained the amended Foreign Investment Act and regulations, the legislature in Yap recently passed further amendments to the Foreign Investment Act to make it somewhat less unpredictable and more restrictive. Yap’s governor is concerned that the renewed arrangement may delay the investment approval process. Similar amendments to the foreign investment legislation are currently being considered also in Chuuk’s legislative branch. In 2011, the Pohnpei government adopted the new Foreign Investment Act (which repealed the previous act) and regulations. It thereby introduced the so-called “traffic-light system,” although the categories are defined differently than in other states.

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40 The FSM Constitution prohibits ownership of land by noncitizens. The constitutions of Kosrae and Pohnpei prohibit ownership even by citizens from other states in the FSM. With some exceptions, land sales across the four states are constitutionally prohibited.

41 To enhance transparency, the FIAS proposed the “traffic-light system,” under which investment proposals are classified into red, amber, or green categories to distinguish between prohibited, restricted, and unrestricted businesses, respectively.

42 Under the revised legal framework, the national government controls foreign investment only in limited economic sectors such as banking, international transport, and fishing in its exclusive economic zone.

43 Businesses that are subject to national regulation may be operated under a national foreign investment permit in any of the four states without the need for additional state-level permits.

44 The amended act requires the establishment of a foreign investment board as a decision-making body (to judge if foreign investment permits are in accordance with economic and social policies beneficial to the state and approve subsequent transfer of ownership interest, among other matters) and mandates that a local partner or partners have a shareholding in any business associated with foreign investments of less than $3 million.

45 The state governor therefore refused to give final approval to the amendments. Nevertheless, as stipulated in the act, the amended act subsequently took effect without such approval. Feedback obtained from interviews during the independent evaluation indicated that these amendments reflected the cautious stance of the legislative body against expected large investment into the tourism industry in coming years from the People’s Republic of China.

46 The proposals include (i) establishment of a foreign investment board as a body to administer the Foreign Investment Act under regulations promulgated by the chief of the concerned government section (under the act); and (ii) introduction of a minimum 35% local investor(s)’ shareholding requirement for wholesale, retail, hotel, and bakery sectors (as designated by the chief of the concerned government section under the regulation).

47 Apart from the traffic-light system, the renewed act in Pohnpei replaces the Investment Board (with seven political appointees and one private sector representative as the decision-making body for foreign investments with a single registrar of companies appointed by the Governor and supervised by the Discretionary Review Panel on Foreign Investment Permits comprising two Chamber of Commerce members, two consumer representatives, and four cabinet members, who had not yet been appointed as of 2013. The panel also is to decide on what types of investments fall into the prohibited red category.
2. Project Loan

   a. Secured Transaction System

38. The FSM government enacted the Secured Transaction Act\textsuperscript{48} in 2005 and operationalized the web-based secured transaction registry in October 2006. The secured transactions law is recognized as a significant improvement compared to the previous legal framework, and is generally in line with good practice standards, with the exception that secured creditors are not paid first (i.e., before tax and employee claims) when a debtor defaults outside an insolvency procedure. The evaluation team could not directly collect any data on (i) actual numbers of registered secured transactions, (ii) the time and costs involved in bankruptcy procedures, and iii) the loan recovery rates on failed business. ADB reports, however, that the numbers of cumulative net filings and cumulative searches had steadily increased from 756 and 473, respectively, in 2006 to almost 3000 each in 2013, thus indicating the basic functionality of the registry.\textsuperscript{49} On an annual basis, the number of searches initially declined from 473 in 2006 to 189 in 2009 during the height of the economic crisis before growing to more than 500 during 2011 and 2012, thus indicating that use of the registry by financial institutions is driven by general economic conditions determining credit demand.\textsuperscript{50} Through the Pacific Private Sector Development Initiative, ADB provided additional TA for an interim upgrade of the secured transactions registry during 2012–2013.

39. During processing of the PSDP, a separate commitment had been made by the five governments to participate in ADB TA with the aim of developing and enacting “balanced and appropriate” bankruptcy legislation. A related performance target was therefore included into the PSDP design and monitoring framework, but not into the policy matrix. No pertinent ADB TA was provided or availed of, however. Although a new Bankruptcy Act was approved in 2005, which is largely based on good practice standards, the estimated recovery rate in the FSM continues to be low at 3.3 cents on the dollar, average recovery time is 5.3 years, and estimated costs total to 38% of the estate in question. No improvement has been reported since 2004.\textsuperscript{51} This might be because the Doing Business surveys base their analysis entirely on information collected in Pohnpei rather than in the other states. The IMF reported that some legal observers expressed concerns that the law grants the states too much power to exempt property from receivership.\textsuperscript{52}

   b. State Land Administration and Management

40. The project loan supported (i) advisory services for strengthening the institutional and technical capacity of land administration agencies for land use planning, surveys, registration, and valuation; (ii) procurement of a land administration information system and land survey equipment for these offices; and (iii) construction of new, purpose-built offices and vaults for records of the Chuuk Land Commission, the

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\textsuperscript{48} This act defines secured transactions as the legal rights and obligations of parties involved in borrowing against movable assets, such as equipment.


\textsuperscript{51} The recovery rate is very low even by regional standards (3\% versus the average of 20\% for Pacific developing countries). The World Bank’s \textit{Doing Business 2015} report ranks the FSM 118\textsuperscript{th} on “resolving insolvency” among 189 economies.

Kosrae Land Court, and the Yap Land Court, as well as renovation of the Pohnpei Land Tenure Court.

41. While the institutional capacity for land management with regard to surveying and mapping reportedly improved, albeit from low levels, unaddressed deficiencies in the underlying legal frameworks continue to affect the full implementation and application of institutional support related to registration, valuation, and dispute settlement. Recommended policy changes such as the privatization of survey services have yet to be adopted and land valuation systems have yet to be formalized.

42. Feedback from implementing agencies indicates that the land administration management information system developed under the project with the aim of creating a linked database for the survey and mapping and land management divisions of the land administrations and the land courts was not fully operationalized. This was due to uncorrectable network system problems and limited implementation support in Kosrae and Pohnpei, as well as a lack of training in Yap. Only in Yap was the digital cadastral survey and mapping system fully operational and all records electronically archived. In Chuuk, the entire computer system of the land office had been severely damaged beyond repair.

43. The constructed offices and vaults are largely in acceptable conditions in all the states except Pohnpei, where the vault was not designed to prevent physical intrusion and air-conditioning was not working at the time of evaluation. Moreover, the vault suffered from water leaks due to poor construction that subsequently required an extra roof to prevent water seepage.

44. The number of land titles, which was used as a proxy for the effectiveness of capacity development efforts under the program, has generally increased for both residential and commercially used land, albeit with yearly fluctuations and with uneven results across the states. In the absence of baseline data it is difficult to determine whether more land was titled during the program than in previous years. Progress with regard to surveying and titling new land parcels appears to have been more pronounced in Kosrae than in the other states. Although private landholders occupy most land in the country, much of this land has yet to be surveyed, mapped, or titled. It is unclear whether the program helped reduce the incidence of land disputes, as consistent data on the number of new land disputes were not available to this evaluation. The pace of resolving land disputes has varied across the states with more progress in Kosrae than in Yap. In Pohnpei the backlog of disputes actually grew during the program period.

45. As a government-owned financial institution, the FSMDB has been mandated to engage in all banking functions that will assist in economically advancing the FSM. It seeks to provide capital funds to eligible and viable projects promoting economic growth and development of the private sector. Historically, its main business focus has been to provide business term loans with priority given to fisheries, tourism, and agriculture-related companies. Since 2008, it added working capital lines, housing

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53 While the Kosrae Land Court resolved 225 land disputes during 2003-2012, the Yap Land Court resolved only 3 of 40 cases filed from 2002 to 2012.
54 Shareholders are the national government and the Chuuk and Kosrae state governments.
loans, and, more recently, consumer financing\textsuperscript {55} to its product lines, which by 2013 accounted for about half of the bank’s new lending. Total loans outstanding increased on average by 4.2\% annually from FY2004 to FY2010 (the program period). During this period, FSMDB remained profitable except in FY2008 when the global financial crisis negatively affected its investment portfolio returns. FSMDB has been investing a substantial portion of its funds. FSMDB’s total outstanding net loans were about $21 million as of the end of 2010, which compared to total assets of $40 million. This ratio has been reduced further since then.\textsuperscript {56} No budgetary transfers from the national government have been recorded in the audit reports since FY2007, as guided by the corporate plan (2005–2014) developed under the PSDP. Feedback obtained at the time of evaluation indicates that FSMDB management was not aware of (and did not support) some of the FSMDB-related output performance indicators under the program. In particular, FSMDB management does not support operational decentralization through delegating more approval authority to the state-level branches, promotion of loans in outer islands, or greater lending to small businesses. Decentralization is deemed unsuitable and lending in outer islands not feasible due to a lack of transport services. Lending has remained heavily concentrated in two states (Pohnpei and Chuuk), which accounted for 94\% of the bank’s loans approved in 2013. Small loans actually declined as a share of total lending during the program period despite simplified small loan appraisal techniques advised on by consultants under the project loan.

d. Small Business Development Centers

46. As explained, the Chuuk, Kosrae, and Yap SBDCs received operational support from the Pacific Islands Small Business Development Center network instead of the ADB-financed project. These SBDCs’ main activities have been business counseling, training, and loan packaging. Construction of the new facilities under ADB’s project loan enabled an increase in the provision of (i) business advisory services in all the three states (in terms of the number of counseling cases), (ii) training (in terms of the range of courses on offer and the number of training sessions and trainees in Chuuk and Kosrae), and (iii) advisory services related to loan applications\textsuperscript {57} in Yap and Kosrae during 2009–2010 from the previous 2 years. The Pohnpei SBDC, which was directly assisted under the ADB project, continuously failed to offer the levels of service that the other SBDCs provide. Business counseling and loan-related assistance are currently suspended, and neither SBDC training services nor College of Micronesia-FSM vocational training courses have been offered as intended. The Kosrae and Yap SBDCs formed and maintained a business development council or advisory board to secure private sector input in the selection and design of business services. Anecdotal feedback from private sector representatives indicates that the SBDC services are useful, but structured satisfaction surveys were not available.

\textsuperscript {55} The IMF (footnote 27) is critical of the FSMDB’s engagement in consumer lending in direct competition with private banks and is concerned about insufficient risk assessment capacity and provisioning against consumer loans.

\textsuperscript {56} As of the end of 2013, net loans and advances comprised 43\% of FSMDB’s $46 million total assets.

\textsuperscript {57} The three SBDCs have kept links with the Pacific Island Development Bank and the FSMDB.
CHAPTER 3

Performance Assessment

A. Overall Assessment

47. Overall, the program is rated less than successful, reflecting the weighted average of the individual ratings for the four criteria relevance (25%), effectiveness (25%), efficiency (25%), and sustainability (25%). Individual criterion ratings are in whole numbers from 0 to 3, in increasing order of program performance. As discussed in the following sections, the program is rated relevant, less than effective, less than efficient, and less than likely sustainable.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Weightage</th>
<th>Rating</th>
<th>Assessments</th>
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<tbody>
<tr>
<td>1. Relevance</td>
<td>25%</td>
<td>Relevant</td>
<td>2.0</td>
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<tr>
<td>2. Effectiveness</td>
<td>25%</td>
<td>Less than effective</td>
<td>1.0</td>
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<tr>
<td>3. Efficiency</td>
<td>25%</td>
<td>Less than efficient</td>
<td>1.0</td>
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<tr>
<td>4. Sustainability</td>
<td>25%</td>
<td>Less than likely</td>
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<tr>
<td>Overall Rating</td>
<td></td>
<td>Less than successful</td>
<td>1.25</td>
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Note: Highly successful (≥2.7), Successful (2.7 > SS ≥1.6), Less than Successful (1.6 > LS ≥ 0.8), Unsuccessful (<0.8).

Source: Independent Evaluation Mission.

B. Relevance

48. Despite some shortcomings, the program is relevant overall. Considered were the following aspects: (i) the program’s consistency with government priorities and ADB’s strategy; (ii) adequacy of the at-entry assessment of bottlenecks in private sector development; (iii) suitability of supported policy actions and institutional measures in addressing identified constraints; (iv) quality of program design; (v) adequacy of policy discussions, stakeholder consultation, and the extent of beneficiary agencies’ participation in program design and their buy-in; (vi) appropriateness of resource allocations and planned implementation support; and (vii) quality of program monitoring mechanisms.

49. The expected results of the program were consistent with the national government’s development priorities and ADB’s regional and country strategies at the time of approval, and remained so at the time of evaluation. The program responded to the FSM government’s shift in policy priorities in the late 1990s, which emphasized improving the business environment. This was subsequently reflected in the FSM Strategic Development Plan (FY2004–FY2023). ADB’s strategy for the FSM at the time of program approval was guided by ADB’s Pacific Strategy for the New Millennium, which identified private sector development as one of five strategic objectives. The ADB

country strategy and program updates for the FSM (2003–2005 and 2005–2006)\(^{59}\) and the Pacific Approach (2010–2014)\(^{60}\) maintained their emphasis on private sector development. The program ensured continuity of ADB’s policy dialogue on public sector management reforms and was well coordinated with efforts of other development partners with regard to macroeconomic reforms and support for private sector development.

50. ADB conducted at-entry assessments through PPTA and other studies in the areas of PSE reforms, foreign investment legislation and regulations, land and collateral issues, and business support services. While PPTA undertook work on specific private sector development issues identified in other regional ADB work, no comprehensive private sector assessment was prepared and published. Findings of a business survey conducted under the PPTA to identify needs for skills training, financial services, and policy changes under the PSDS were not available to the evaluation. With regard to the appropriateness of the overall program focus, it is noteworthy that a 2009 World Bank survey of private enterprises found inadequate education levels of the work force to be the main obstacle to those enterprises’ better performance followed by infrastructure issues related to electricity supplies and transportation. Focus areas of the PDSP-supported policy agenda were perceived to be lesser concerns. Inasmuch as there are no comparable survey results for the beginning of the program period, it is difficult to determine whether the focus on regulatory reform and property rights—although in line with international development paradigms and based on good practice standards—was indeed the best approach to promoting private sector development in this particular country.

51. There were some weaknesses regarding the design and formulation of individual policy actions. For example, ADB’s conditionality related to FSM’s fiscal management was questionable on four accounts: (i) maintaining a “balanced budget” was already a constitutional or statutory requirement for the national and state governments, thus little additionality was associated with such a program condition; (ii) a “balanced budget” as defined under the PSDP was not synonymous with prudent fiscal management, as all tax and nontax government revenues and grants were considered as part of fiscal revenues, whereas only current expenditures (and not capital expenditures) were included in ADB’s definition; (iii) the ADB definition was not aligned with government or IMF definitions and related data sets were not readily available; and (iv) the achievement of budgetary self-sufficiency in the run-up to discontinuation of the US Compact grants in 2023 will require significant increases in fiscal surpluses. Moreover, experience from the late 1990s in conjunction with the PSRP underscored the need for strategic restructuring of department operations to sustain government efforts to consolidate the public sector.\(^{61}\) In the evaluation team’s view, the PSDP should have more explicitly addressed this issue. Continued inefficiency in department operations, coupled with difficulties in adjusting to the renewed Compact arrangements, subsequently resulted in the implementation of reduction in force, another round of painful, drastic staff reduction, in the two states. Given the small size and even temporarily contracting economy and significantly different attitude and skills sets needed by the private sector, the assumption that redundant civil servants, although compensated, could be absorbed by the private sector was unrealistic.


\(^{60}\) ADB. *ADB’s Approach to Assisting the Pacific (2010-2014).* Manila

52. Despite rounds of feedback from stakeholders, unexpected delays in obtaining legislative support for the program both at national and state levels after the appraisal call into question the adequacy of the consensus-building efforts as well as the program readiness at entry. Moreover, most beneficiary agencies’ lack of awareness of—and in the case of FSMDB disagreement with—respective output targets indicate inadequate buy-in for the program.

53. Buy-in for the reform agenda also lessened when external pressures for policy reform efforts eased with the approval of Compact II. The program had been designed at a time of uncertainty that there would be a Compact II stream of budget support from the USA and there was great national drive to get the house in order.

54. The PIU was constrained by understaffing and weak support from (and coordination among) the relevant national and state agencies throughout program implementation. Moreover, inasmuch as the PIU’s international program manager was not assigned to look after the policy aspects of the program, virtually no support had been provided for this purpose until the small-scale TA consultant was fielded in 2005. As such, inadequate resource allocation for implementation support was an evident issue in the program design. Extra resource allocations would have been justified in view of the hybrid nature of the program, the weak capability of the implementation agencies, and the PIU’s limited authority over state administrations in the complex political environment.

55. The quality of the design and monitoring framework for the program was weak, as it lacked monitorable targets and baselines. For example, “investor confidence” was to be measured by an “annual rapid ‘quick and easy’ business survey,” but undertaking of such survey was not incorporated into the program design and thus it was never implemented. “Number and performance of businesses” were to be measured based on business registration records, but these are not open to the public and could not be accessed by the evaluation team. Moreover, “business” and “performance” were not clearly defined. “Number of land lease and mortgage transactions” were to be measured based on land registration records, which again were inaccessible for evaluation purposes. Also, most leases and mortgages are reportedly not registered with the state land offices. Intended program outcomes refer to “access to and competitiveness of... labor” (in addition to land and capital), but no corresponding performance targets were identified. The project design provided no support for the collection and reporting of relevant monitoring data. Another weakness arose from the policy matrix’s lack of clarity with regard to some of the end-of-program targets. For instance, the policy matrix envisaged a liberalization of external debt policy without defining what exactly this meant. Moreover, because underlying policy principles for required policy actions were not specified, it is difficult to determine what was being expected of the government.

56. Moreover, the timelines set for all the program outcome targets (i.e., 2002–2004) were too tight given local capacity constraints and inappropriately linked with the overall envisaged program period (i.e., 2002–2006). This evaluation is of the view that program outcomes also should have reflected achievements under the project loan, which was to be implemented over 4 years.

\[62\] For another example, it envisaged “fiscal position...strengthened with level of financial reserves maintained or increased” but did not define “financial reserves.” Likewise, it envisaged reduction of the “real wage bill” and “nonwage operating expenditures” but did not define these terms.
57. In general, the design of the investment project with its various elements across each state was too complex and ambitious given local capacity. Moreover, the program design did not account for institutional and political constraints upon achieving fundamental reform in a fragile and conflict-affected country. Instead, it relied on continued external pressures to ensure sustained internal support for reform.

C. Effectiveness

58. The program is less than effective. It sought to (i) develop a sound economic and legal environment conducive to private sector development; and (ii) improve access to land, labor, and capital resources to increase business prospects and performance. Most related performance targets were either not met or could not be fully assessed due to the lack of adequate monitoring mechanisms and available data. Few data are available to assess trends in business formation and performance. While slightly more enterprises were established during 2004-2007 than in the 4 years preceding the program, no data on enterprise registrations could be obtained for the period after 2007. Furthermore, while the PCR concluded that business turnover improved based on average annual increases in paid gross revenue taxes of about 1% over the program period (FY2004–FY2008), revenues decreased in real terms. Average gross tax revenues received from enterprises increased during FY2009–FY2012, but it is unclear to what extent this development was actually driven by improved enterprise performance rather than a larger number of registered tax units or enhanced efforts to collect corporate taxes. It is unlikely that investor confidence improved significantly during the program period or thereafter. Reliable data series for domestic and foreign direct investment are not available to quantify actual interest. Envisaged annual rapid business surveys to ascertain confidence levels in a qualitative way were not conducted. The World Bank’s FSM Doing Business 2014 report showed little improvement in the FSM’s overall business environment from 2005 to 2013, except that the “getting credit” indicator improved. That indicator reflects introduction of the secured transaction framework, which has not yet fundamentally improved access to finance. Unsurprisingly, the overall achievement of program outcomes was mixed at best. As pointed out in this report’s section on outputs (above), a significant number of policy actions were not fully implemented and there were some shortfalls in project loan outputs. In many areas, moreover, there is no substantial evidence linking developments at the outcome level to achieved program outputs.

59. Economic environment. The FSM’s macroeconomic environment has moderately improved over the decade as the result of ADB-supported efforts to restore fiscal balance, maintain sound debt management, and establish the CTF. There has been some progress in restructuring public sector commercial activities, although the level of government involvement in economic activities remains largely unchanged. Wage differentials between the public and private sectors did not change much and remained at high levels during FY2004 to FY2012, while public sector employment declined by an average 1.5% annually and private sector employment increased by 0.8%.

60. Legal environment. There has been some improvement in predictability and functionality of the legal framework through the enactments of legislation on foreign investment, leasing, mortgage, secured transactions, and bankruptcy at both the

63 As none of the performance indicators for the economic and legal environment identified in the design and monitoring framework could be used at the time of evaluation (para. 55), this evaluation refers to this indicator as a substitute.

64 The PSE share in GDP actually grew from 7.0% in FY2004 to 8.6% in FY2009 and 9.5% in FY2012.
national and state levels. All states have incorporated the “traffic-light system” into their foreign investment acts. Harmonization across the five jurisdictions still lags, however, and there is not much evidence that the improved legal environment has promoted foreign investment inflows. Among the four states, Kosrae and Yap adopted leasehold legislation in line with good practices, but only Kosrae also enacted mortgage legislation. The evaluation team could obtain no data on the number of leases and mortgage transactions. While the supported secured transaction legislation provides a solid basis for the use of movable collateral and has led to an increase in secured lending, new bankruptcy legislation is deemed unlikely to be effective (see para 39).

61. **Access to land and finance.** Access to, and security of, land ownership and use for commercial purposes remain constrained. Deeply rooted customs and the tradition of communal land tenure complicate any comprehensive reform of the land system. Liberalization of land ownership and user rights is a politically and culturally sensitive issue. While improvements in the legal basis for land leases and in the institutional capacity for land management under the program in Kosrae and—to a lesser degree—Yap will likely facilitate commercial land use at least in Kosrae, similar outcomes are unlikely in Chuuk or Pohnpei.

62. Difficulties in obtaining secure, transferable land tenure have been a major constraint upon domestic and foreign investment in the FSM. Issues surrounding land ownership and use rights also continue to impede the use of land as collateral, thereby limiting access to finance. Given the difficulties in using land as collateral, the secured transactions framework established under the program is considered an important step toward improving businesses’ access to finance. It has gradually enhanced the use of movable assets as collateral by commercial banks and FSMDB and facilitated lending to new customers. Notwithstanding the level of progress made, bankers commented that broader acceptance of movable assets would depend on the time and costs associated with the seizure and disposition of collateral and distribution of proceeds, which have not been well tested.

63. It can be argued that the new secured transaction framework, together with other factors, likely contributed to the rapid but temporary increase in commercial lending volumes within the first 2 years of its establishment (i.e., in 2007 and 2008) and facilitated the increase in consumer lending from 2010 onward (Appendix 2, Table A2.5). Overall, however, financial intermediation levels did not change much and domestic credit to the private sector as a proportion of GDP stood at 18.6% in 2013 compared to 20.9% in 2002 (Appendix 2, Table A2.6). In view of potential enforcement problems and the absence of credible credit information, collateral requirements have been high. High, too, are interest rate margins, which declined slightly over the program period before increasing again to pre-program levels of about 14% after 2008 (Appendix 2, Table A2.7). Thus, borrowing is expensive. Banks do not particularly seek to promote small loans and rarely accept loan applications coming out of the SBDCs’

65 It appears progress in Yap will depend upon first resolving legal impediments to land registration.

66 Two commercial banks operate in the FSM: the Bank of FSM and the Bank of Guam. Bank of FSM’s shareholders are spread across the four states, and Bank of Guam is foreign-owned. As possession of land is legally and customarily closely tied with the origin of people (i.e., which state one is from), commercial banks are concerned about social acceptability of using land as collateral. Also, banks pointed to the cumbersome and costly process for enforcing security interests in the form of immovable assets. In contrast to the two commercial banks, FSMDB has been accepting land as collateral and is actively using mortgages. According to FSMDB, although the foreclosure of mortgages was legally supported, the disposition of seized properties often results in low recoveries due to lack of a formal property market, compounded by cultural reluctance to acquire repossessed assets. Both commercial banks and FSMDB do not normally take leases as collateral, because they are rarely registered with the state land offices.

67 The 2009 enterprise survey reported average collateral values at 265% of loan values.
loan packaging because they are concerned about the quality of appraisals. Average bank loan-to-deposit ratios have been declining and reached 25% in 2013, thus reflecting that banks would rather invest deposits abroad than to finance economic activities within the country. Enterprises surveyed in 2009 reported unusually high levels (88.7%) of self-financing of investments from internal resources. Nevertheless, at 24%, the share of enterprises which considered a lack of adequate finance to be a major business constraint was in line with global survey results. Eight percent and 5%, respectively, of survey respondents identified lack of access to finance and land as the main impediments to doing business. No baseline survey is available to help ascertain to what extent perceptions in these two areas improved over the program period.

64. **Access to labor.** SBDCs in the three states (i.e., Chuuk, Kosrae, and Yap) have regularly offered a variety of business skills training courses to support business development. Key customer groups include tourist-related businesses, value-added businesses (local handicrafts), agri-businesses, businesses with export potential, minorities, low-to-moderate income households, and youth organizations. The FSM government expressed the view, however, that SBDCs were still being underutilized. Data to assess whether business formation and self-employment levels increased among SBDC training participants or countrywide during or after the program period were not available to the evaluation. Evaluation informants underscore the shortage of skilled labor in such specific economic activity areas as construction, agriculture, aquaculture, and tourism. Vocational training is needed to address these areas. In 2009, half of surveyed enterprises identified the lack of an adequately educated workforce as a major business constraint. Several informants pointed out that reduction in force in Chuuk and Kosrae caused considerable outward migration of comparatively well-educated and skilled segments of the working age population.

D. **Efficiency**

65. The program is *less than efficient*. Implementation of both the policy and project loans was significantly delayed and not all allocated program resources were utilized. While the extent of resource efficiency is unclear, there appears to have been a positive relationship between financing provided and the levels of program achievements at the national level and in Kosrae. Results were less favorable in the other states. A number of project expenditures produced no sustainable outputs or outcomes.

66. **Policy loan.** Due to several states’ noncompliance with second tranche release conditionality, ADB actually disbursed only 71% of the total approved program loan amount. Loan closure was delayed by 2 years from the original target due to the slow progress in reforms. The RRP estimated program-related adjustment costs of $5 million to be incurred as a result of the envisaged PSE reforms. The actual costs incurred in conjunction with PSDP implementation were likely lower. Moreover, not all counterpart funds were utilized for the earmarked purposes (para. 12). The evaluation informants commented that the counterpart funds were not used transparently in Chuuk or in a cost-effective manner in Yap. No comments were provided from other states.

67. **Project loan.** Loan closure was delayed by more than 3 years and 6 months from the original target, and ADB actually disbursed 83% of the total approved loan amount. Although inputs were delivered in accordance with the original design for most components under the project loan, inputs related to land administration management information system technology at FSMDB and advisory services for the
Pohnpei SBDC were not converted into expected outputs. Specifically, the vault built for the Pohnpei Court for Land Tenure did not meet the envisaged quality standards.

E. Sustainability

68. The program’s sustainability is less than likely in view of (i) program implementation agencies’ limited capacity and incentives for taking appropriate follow-up actions to attain better results, (ii) their resource constraints, and (iii) difficulties in building nationwide consensus on the direction and pace of necessary fiscal reforms in the near term.

69. Those policy reforms achieved have been largely sustained, although political commitment has been wavering in a number of areas related to fiscal and land reforms. To further enhance broad public and political support for these and other efforts to improve the business environment, it will be necessary to demonstrate tangible results in the forms of reduced transaction costs, improved service levels, and increased access to finance and land. The evaluation team observed weak results-orientation on the part of government agencies dealing with private sector-related issues. For example, none of the state government staff involved in land administration met by the evaluation team was aware of trends in land titling, dispute resolution, and mortgage registration, and there were no related performance targets (e.g., to reduce time and costs associated with registration approvals). Most of these offices do not appear to give priority to improving service quality. No pertinent staff performance incentives are in place.

70. The future availability of adequate funding to maintain program outputs and outcomes will depend on further progress with overall fiscal reforms. The annual decrement under the Compact II implies a 20% (or annual average of approximately 2%) reduction in real resource flows during FY2013–FY2023. Long-term fiscal frameworks, which outline the fiscal adjustment path needed in response to declining Compact resources and determine available budget allocations, have been prepared by all states.\textsuperscript{68} The long process of FSM-wide tax reform (i.e., introduction of a net profit tax and a value-added tax) is also finally making progress, having been approved by the national government and two state governments. This will not take effect, however, until the remaining two states (Pohnpei and Yap) will approve the reform, and there still remains significant opposition that could derail the process.\textsuperscript{69} To complement the long-term fiscal frameworks and revenue reform, the FSM’s president proposed in 2012 to establish the “2023 Planning Committee” with an aim to develop a realistic action plan for addressing the looming budgetary shortfall from FY2014 onwards. The Congress, however, rejected full appropriation of the proposed budget for this committee.\textsuperscript{70} The FSM government continues therefore to face a series of challenges in building nationwide consensus on necessary fiscal reforms, thus posing high risks for fiscal sustainability (footnote 27).

\textsuperscript{68} The initial work of the FSM government in preparing the long-term fiscal framework started in 2010 was rejected by the four states, which viewed the draft framework as not reflecting the state’s priorities. Preparation of a second round of state-generated frameworks was completed in early 2013. It was decided not to prepare a framework at the national level.


\textsuperscript{70} The Congress also rejected the President’s proposal to allocate $1 million to the CTF from the FY2013 budget.
71. Resource conditions of the state land offices and courts vary across the states. The Chuuk Land Commission is particularly constrained by inadequate budget and space allocations. None of the land administrations charge fees sufficient to sustain their operations and all depend on annual budget allocations funded from the private sector grants under Compact II. The provision of land management-related training courses through the College of Micronesia under the program should have facilitated continuity of skills training on topics related to land management for land administration staff and others, but relevant courses were not maintained.

72. The fee-for-service principle originally envisaged for business development services and which was to ensure financial sustainability was not introduced. The Pohnpei SBDC is currently not functional due to a lack of funding, while SBDCs in other states remain in operation. The Chuuk, Kosrae, and Yap SBDCs became part of the Pacific Islands Small Business Development Center network during 1999–2002 and have been partially financed by the US Small Business Administration under cooperative agreements. Compact II private sector grants provide supplemental funding through the respective state governments, subject to the decrement of the Compact grants. The Pohnpei SBDC remained dependent on state government budget appropriations since commencing its operations in 2006.71

73. The evaluation team could obtain no relevant information on the level of self-funding and any required resource transfers for maintaining the secured transaction system, although it has reportedly continued to work well.

F. Institutional Development

74. The institutional development impact is moderate. This reflects the extent to which laws, regulations, and procedures related to business development have been improved, as well as to which performance and capacity of relevant organizations have been enhanced.

75. Introduction of the secured transaction law and registry is considered the major achievement under the PSDP. Enactment of the Leasehold Act and Mortgage Act in Kosrae (but not other states) created a legal basis to enhance the access to land and finance. The “traffic-light” system introduced by all the five governments in their foreign investment legislation is expected to facilitate a transparent and predictable approval process for investment applications. The IMF (footnote 27) is of the view that addressing issues regarding obtaining longer-term land leases and burdensome procedures for approving foreign investments would further facilitate such investments.

76. The operational efficiency of land offices appears to vary across the states. The Yap Land Court has most effectively upgraded its equipment for land surveys and data management under the PSDP. Not much information is available to reliably attribute PSDP’s contributions toward enhanced staff skills and systems for state land administration and management.

77. The PSDP supported the FSMDB’s preparation of a 10-year strategic plan (2005–2014) which helped it become financially viable. Its operational focus shifted,

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71 The original plan envisaged the national government’s partial allocation of its College of Micronesia-FSM budget to SBDCs, except in Yap where it would be channeled through the state government. However, this plan was adjusted in conjunction with the three SBDCs’ participation in the Pacific Islands Small Business Development Center network and allocation of the Compact private sector development grants to SBDCs through state governments.
however, from development to commercial finance and with an emphasis on consumer rather than corporate lending. The envisaged expansion of FSMDB’s banking and business advisory activities to outer islands did not materialize as planned due to a lack of commercial viability.

78. Actual support for business development services comprised mainly the construction of physical infrastructure. Institutional development outcomes were largely achieved through assistance not financed by ADB.

G. Impact

79. In view of limited progress toward achieving the program impact performance target, the program impact is moderate. Greater private sector contributions to GDP and employment growth did not occur during and after program implementation.

80. During the past decade, real incomes in Micronesia have stagnated and job prospects deteriorated even as outmigration has been rising in response to a lack of economic opportunities. The performance of the country’s sectors having comparative advantage (i.e., agriculture, fisheries, and tourism) has not lived up to expectations. Following mostly negative growth during FY2004–FY2008 due to the reduction in Compact grants and delays in their use, the FSM economy grew between 0.0% and 3.2% annually in real terms during FY2009–FY2012 (Appendix 2, Table A2.8), before contracting by 4% in FY2013. That recent decline was due to a sharp drop in construction activities upon completion of US Federal Aviation Administration projects and continued internal capacity issues that constrained the utilization of infrastructure grants. Earlier growth had been driven mainly by new construction activities in the public sector, such as the Pohnpei airport renovation and other infrastructure projects across the states, as well as by high fishing fee revenues.

81. The program has not been transformational in changing the basic economic structure and the relative roles of the private and public sectors in economic development. The economy remains dominated by the large public sector (accounting for nearly 40% of GDP) while the private sector’s share in GDP decreased slightly from 24% in FY2004 to levels of 21% to 23% during FY2005–FY2013 (Appendix 2, Table A2.9). In real terms, the level of private sector output actually declined during the program period and, despite some growth during FY2010–FY2011, it remained below the FY2004 level thereafter (Appendix 2, Table A2.10). At the same time, however, the overall share of private sector employment in total formal employment did increase slightly from 42.8% in FY2004 and 42.7% in FY2008 to 44.5% in FY2012, albeit with declining numbers of private sector employees. Contrary to what was anticipated during design of the program, the private sector did not absorb retrenched public sector employees. In fact, the total and relative number of civil servants was higher in FY 2012 than at the beginning of the program in FY 2004, thereby to some extent making up for reduced employment by other government agencies and public enterprises (Appendix 2, Table A2.11).

73 The total number of private sector employees, which had initially declined throughout the program period from 7,007 as of FY2004 to 6,382 in FY2008 in line with overall reduced employment levels, actually increased above pre-program levels during FY2009–FY2011 before contracting again thereafter to 6,793 as of the end of FY2012.
82. A more differentiated analysis of developments by state shows no clear positive link between the level of reform effort and private sector growth. Kosrae, which was the only state to largely implement the reform agenda promoted under the program, temporarily had higher rates of economic growth than the other states and experienced a gain in private sector output, both in absolute terms and as a share of overall GDP before its economy sharply contracted in FY2013. While overall employment levels decreased, the share of private sector employment slightly increased until FY2012. In the case of Yap, which had focused on private sector-related legal reforms and institutional development but did not pursue fiscal consolidation, private sector output and employment declined in absolute and relative terms over the program period and beyond. By comparison, Chuuk, which had adopted fiscal reforms rather than some of the other policy measures, showed improvements in private sector contributions to growth, albeit at a lower level than did Kosrae. Finally, the state economy of Pohnpei, which had largely failed to implement required policy measures and institutional reforms, grew as the result of public infrastructure investments, while the share of private sector activity in total economic output remained largely stable. The number of related private sector jobs also rose there.

83. The program was classified category C for potential environmental impacts and risks, thus requiring no environmental management plan or resettlement action. The evaluation team found no program-related environmental issues or adverse environmental impacts during implementation. Moreover, the mission found no land acquisition or involuntary resettlement issues. There were no concrete indications of women being disproportionately affected.
A. ADB Performance

84. ADB’s performance is rated *satisfactory*. This evaluation considered (i) the adequacy and timeliness of ADB supervision during program implementation, including the frequency and length of inception and review missions; and (ii) ADB’s responsiveness and high client orientation throughout the implementation period. However, the following aspects were also noted: (i) the policy matrix lacked clarity with regard to expected government actions; (ii) ADB did not undertake (or allocate resources for) the annual “quick and easy” business survey envisaged in the program framework; (iii) ADB did not provide meaningful supervision of IT-related project components; (iv) ADB has not properly kept key documents, including the consultant reports for the two related TA projects (i.e., PPTA 3278-FSM and TA 2758-FSM), thereby constraining this evaluation.

B. Borrower Performance

85. The borrower’s performance is rated *less than satisfactory*. The rating reflects the following findings from the PCR: (i) the national government was not always committed to smooth and timely program implementation, and especially after 2007 the national government failed to provide adequate staff to perform the PIU functions; (ii) the program’s financial administration was below the standard necessary for timely renewal of the imprest account, thus adding to further delays in program implementation; (iii) the national steering committee functioned only until a change in departmental responsibilities in 2007, after which no records are available for committee meetings or decisions; (iv) the Department of Economic Affairs’ overall coordination with states was weak in the latter part of the program; and (v) the national government did not submit certified copies of the audited financial statements and a program completion report to ADB. This evaluation validates these findings based on review of program documents and supplemented by field interviews. In addition, delays in implementation precipitated numerous changes of counterpart staff at the state and national levels, which in turn led to further delays and changes in government priorities and relationships.
CHAPTER 5

Issues, Lessons, and Follow-Up Actions

A. Issues

86. **Fiscal consolidation through cuts in current expenditures will not be sufficient for achieving budgetary self-sufficiency by FY2023.** These need to be accompanied by structural reforms that can enhance the efficiency and effectiveness of public sector management and support private sector development. Reportedly, virtually all of the burdens of fiscal adjustment envisaged under the long-term fiscal frameworks fall on reducing unprioritized and ad hoc expenditures to meet the anticipated 20% reduction in Compact assistance from FY2013 to FY2023. While there is no doubt that the planned expenditure measures, along with the planned tax and financial management reforms, are key to a realistic fiscal adjustment path, it is also important to consider how public sector management can be improved to boost efficiencies. Potential measures should include (i) greater private sector involvement in providing public services, leaving government to focus on functions that only governments can perform; (ii) introduction of results-based management approaches for government institutions that include setting transparent institutional performance targets and accountability of government employees for their delivery, and (iii) improvements in interdepartmental and intergovernmental coordination (i.e., between national and state governments). Such reforms are best tackled while taking a long-term perspective, but prior to expiration of the current Compact in FY2023. Greater results- and service-orientation of government agencies would also help private sector development, as would reliable collection, analysis, and dissemination of data relevant to business decisions.

87. **The wage differential between the public and private sectors remains significant.** This differential continues to be a relevant parameter in view of the country’s stated development agenda in pursuit of private sector-led growth. Salaries paid by the national and state governments in FY2012 were on average 3 times and 1.8 times higher, respectively, than were private sector wages. The comparable multiple for public enterprise wages was 2.6. The FSM government is of the view that qualifications required in the public and private sectors are not comparable and that wage cuts or freezes would come at the risk of losing better qualified staff and accelerating outward migration. The experience of other Pacific developing member countries with similar economic conditions and outward migration who have managed to arrive at more favorable public/private sector wage ratios should be reviewed.

88. **The economic presence of PSEs remains high and poses fiscal risks.** There has been some progress in PSE restructuring, and budget transfers to PSEs have been declining over the years. Some PSEs are still in direct competition with the private sector, however, and their economic presence remains significant at 10% of GDP. In part, this figure reflects the establishment of Petro Corp., which took over the private sector assets and operations in the FSM in 2008. Utilities and public service providers
pose sizable contingent liabilities for public finances in the event that their financial positions deteriorate. The IMF (footnote 27) recommends that the FSM government further strengthen the oversight and accountability of PSEs, in particular those in electricity and telecommunication, which are critical services for private sector development.

89. **There is no functioning mechanism to ensure rule-based, fair competition.** Several evaluation informants observed that competition between public and private enterprises, within the private sector, as well as between local enterprises and those from other states or abroad, was limited. “Whatever the rules and regulations, whatever the written policies and statements of government,” remarked one senior ADB staff member with long-standing research experience in the FSM and other Pacific countries during internal review of this appraisal document, “when a new private proposal, especially from outside the individual state (whether foreign or from the other FSM states) threatens existing commercial interests, then indigenous interest will prevent competition.” While the extent of this issue may be uneven across the states, this reaction indicates the need for an effective mechanism to ensure rule-based fair competition. Although general competition legislation appears to be in place, it is largely limited to the trade in goods and anticompetitive arrangements in relation to services are not included. The simplicity of the law requires judicial development of the area. Also, access to services and pricing are not covered. Consumer protection provisions do not cover unconscionable conduct and unfair contracts. Moreover, in the absence of a specialized competition commission, administration of the legal framework is court-based and there has been a general lack of enforcement activity. The feasibility of adapting a model regulatory and policy framework developed for the Pacific Island Forum and establishing an effective enforcement mechanism at the national or regional level should be assessed.

90. **Limited access to land and finance still constrains business development.** The land system in the FSM is intricately connected to people’s perception of inheritance and community. Land-related issues are deeply rooted and need to be addressed over the longer term. Nevertheless, the nature and degree of such issues appears to vary across the states. For instance, traditional communities’ influence is lesser in Kosrae and, perhaps for this reason, land access seems less restrictive. Therefore, the new land lease legislation and upgraded Land Commission have a better chance of succeeding and contributing to private sector development in Kosrae than in the other states. Emerging impacts need to be monitored and success stories shared with decision makers in other states. Given the continuing underlying political and legal problems with land ownership, transfer, and mortgaging, only FSMDB is actively using land as collateral even as both commercial banks and FSMDB have been gradually accepting movable assets as collateral. Banks noted that broader acceptance of collateral would largely depend on time and costs required to enforce it, which will require greater clarification of the legal framework with regard to prioritizing secured creditors, the development of markets for assets and judiciary support. Corporate lending is also constrained by low recovery rates in cases of business bankruptcies. The capacity of courts needs to be improved to ensure effective and efficient enforcement. As credit assessment is fundamental to any kind of lending, the ability to access reliable credit history is as important as functioning secured transactions systems, particularly in situations where the use of immovable property is constrained.

Private sector development strategies are lacking. The absence of a shared strategic vision for and approach to private sector development has contributed to a lack of results orientation, broad-based political and institutional support, and coordination of related reforms. The 2012 FSM Development Framework recognizes the critical role of private sector development. The framework’s first priority is to improve the “business enabling environment.” It also designates agriculture, fisheries, tourism, external and intrastate trade, and renewable energy as priority economic sectors and emphasizes the importance of business skills development. Various local and foreign businesspeople interviewed for this evaluation see good commercial potential in the aforementioned priority economic sectors, which are in principle private sector-based.

The FSM government together with any interested state governments and the private sector should devise strategies that identify and address general as well as industry-specific legal, regulatory, policy, infrastructure, skills, and institutional constraints upon developing these sectors and attracting domestic and foreign investment. While the national-level strategy should focus on areas of mutual interest that are best addressed at the national government level, to ensure adequate buy-in there is also a need for state-based assessments and action plans that reflect each state’s private sector development priorities. Compact private sector grants could be linked to the implementation of such strategies.

B. Lessons

Ascertaining legislative support at both the national and state levels is an important aspect of determining project readiness in the FSM. The unexpected delays in obtaining national and state legislative authorization delayed the loan approval and loan effectiveness, each by 1 year, respectively. Reform momentum was lost during the long interval between appraisal and program inception.

Policy actions must be formulated in a manner that does not leave room for ambiguity or interpretation of supported policy principles. A large number of policy actions under PSDP were not sufficiently defined to ensure or help ascertain the achievement of meaningful results. Examples include conditionality related to balanced budgets, wage differentials, or the adoption of new laws which did not convey the underlying principles that ADB expected to be realized and contributed to differences in understanding between ADB and the various governments regarding the nature of expected reform actions.

A design and monitoring framework can be an effective instrument to attain results only if it is properly shared with implementing agencies and provides clear performance targets with appropriate timelines, monitoring mechanisms, and baseline data. Sufficient resources and time should have been allocated for consultation with implementing agencies in determining program inputs, outputs, and outcomes, as well as in setting and monitoring performance targets. To be effective, ADB must ensure that these can contribute to sustainable development of local economies and communities.

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75 The Development Framework was presented by the national government during the first Development Partner Forum held in Pohnpei in November 2012.
76 The evaluation informants included a local vegetable farmer and exporter, a former municipality mayor who is also an organic farmer, and a foreign agricultural advisor in Kosrae; a local organic food promoter and specialized agricultural product exporter in Pohnpei; foreign eco-resort hotel owners in Kosrae and Pohnpei; a local small-scale fishery plant owner and exporter, and a foreign aquaculture plant owner and exporter in Yap; as well as a foreign, small-scale commercial complex owner in Chuuk. Their experiences demonstrate good potential in the respective activity areas and that these can contribute to sustainable development of local economies and communities.
77 Strategies and their underlying analysis should distinguish clearly between measures that can be achieved at the state level and measures that require federal approval and action.
that systems to monitor the achievement of performance targets are in place or are established in time. State government offices could not provide complete sets of foreign investment data. National government offices could not provide data on secured transactions, registered businesses or enterprise performance. Land administrations did not have reliable data on the land titles or leases.

95. Consider targeting support for reform initiatives in the FSM at individual states. Decentralized practices among the four states (Chuuk, Kosrae, Pohnpei, and Yap) make coordination and communication on policy issues a challenge.\(^78\) This challenge was compounded by the weak capacity of various implementing agencies and different views and levels of political commitment regarding the reform agenda. These resulted in varying degrees of performance. Through state-specific policy conditionality and project components, program design could have been adjusted for the uneven capacities, needs, and levels of political buy-in within the four states. While it can be argued that the uniform approach adopted by ADB was reasonable in light of resource constraints and efficiency concerns, it also needs to be considered that potential for synergies was limited and not sufficiently identified.

96. Program implementation arrangements in the FSM need to recognize the limited authority of a program implementation unit at the national level over state administrations.

97. IT-related project components need extra attention from ADB in small, remote countries with low capacity. From the start, the IT components for the land management administrations and FSMDB were not properly scoped and resourced. They did not adequately consider the limited capacity of internal IT departments and local IT providers. They also failed to address such related problems as the need to provide implementation support throughout the first year of operation. Although project records are patchy and likely do not reflect the full extent of ADB’s involvement, it appears that ADB relied on short-term consultants to determine IT systems and software requirements and to supervise software and hardware providers. Given the lack of specialized staff expertise in the Regional Department, the complexity of these project components, and the low capacity within the supported agencies, proactive consultation with ADB’s Office of Information Systems and Technology during the project design phase might have resulted in more appropriate IT solutions. Also useful could have been to provide specialized IT expertise within the PIU, more proactive follow-up during implementation to check the functionality of procured hardware and software, and special arrangements for post-implementation support. Furthermore, it would be helpful if the Regional and Sustainable Development Department together with the Office of Information Systems and Technology can collect and disseminate information about experience across ADB with relevant IT applications. While IT-projects can be particularly useful for small, remote economies, inherent IT capacity issues need to be proactively addressed.

98. Public enterprise reform in the FSM requires creative approaches to involving the private sector in the management of public assets given limited private sector capacity and interest. The effort to reform and divest public enterprises has not been as successful as hoped. One reason is that in such a small and remote lower-income country with a weak private sector, there are few people with the capital or business experience to bid for or successfully manage such enterprises.

\(^78\) Not only do the four states have significant autonomy, but they are also geographically widely scattered. For example, Yap is closer to the country Palau than it is to Pohnpei.
C. Follow-up Actions

99. No separate follow-up actions were identified for the borrower or for ADB.
A. Linked Document A: Program Framework

B. Linked Document B: Achievements of Program Targets

C. Linked Document C: Status of Policy Matrix

D. Linked Document D: Key Program Data

E. Linked Document E: Loan Covenants
### Table A2.1: Federated States of Micronesia: Overall Fiscal Balance (% of GDP)

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= negative, FSM = Federated States of Micronesia, FY = fiscal year, GDP = gross domestic product.


### Table A2.2: Federated States of Micronesia: Government Payroll Expenditures ($ million)

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

### Key Economic Indicators

#### Table A2.3: Federated States of Micronesia: Average Annual Nominal Wage ($)

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<td>12,045</td>
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<td>12,746</td>
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<td>14,632</td>
<td>14,785</td>
<td>14,471</td>
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<td>15,783</td>
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<td>8,829</td>
<td>9,152</td>
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For Chuuk, Kosrae, Pohnpei, and Yap:

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<th>8,911</th>
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For Kosrae:

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<td>8,888</td>
<td>8,929</td>
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For Pohnpei:

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For Yap:

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_FSM = Federated States of Micronesia, FY = fiscal year._
### Table A2.4: Federated States of Micronesia: External Debt (% of GDP)

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<tr>
<td>External debt</td>
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<td>25.1</td>
<td>25.7</td>
<td>28.4</td>
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<tr>
<td>External debt adjusted for offsetting assets</td>
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<td>16.0</td>
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<td>17.2</td>
<td>17.5</td>
<td>17.1</td>
<td>17.9</td>
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FY = fiscal year, GDP = gross domestic product.

Source: Department of Finance and Administration and EMPAT estimates provided in Graduate School USA, Pacific Islands Training Initiative. 

### Table A2.5: Federated States of Micronesia: Commercial Bank Lending ($ million)

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<td>Total Loans Outstanding</td>
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<td>30.0</td>
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<td>21.7</td>
<td>22.2</td>
<td>25.3</td>
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FY = fiscal year.

Source: FSM Banking Board data provided in Graduate School USA, Pacific Islands Training Initiative. 2014. 

### Table A2.6: Federated States of Micronesia: Domestic Credit to Private Sector (% of GDP)

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<td></td>
<td>29.1</td>
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### Table A2.7: Federated States of Micronesia: Interest Rate Spreads (Lending rate minus deposit rate, %)

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### Table A2.8: Federated States of Micronesia: Real GDP Growth Rates (%)

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− = negative, FSM = Federated States of Micronesia, FY = fiscal year, GDP = gross domestic product.


### Table A2.9: Federated States of Micronesia: Share of Nominal GDP by Institutions (%)

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| **Public Enterprises** |        |        |        |        |        |        |        |        |        |        |
| FSM    | 7.0    | 7.1    | 6.4    | 7.2    | 7.2    | 8.6    | 8.1    | 8.1    | 9.5    | 8.4    |
| Chuuk  | 2.8    | 3.1    | 2.4    | 2.5    | 3.2    | 6.5    | 4.5    | 4.0    | 4.9    | 5.0    |
| Kosrae | 8.5    | 6.6    | 6.4    | 6.0    | 5.4    | 6.6    | 8.3    | 6.9    | 6.2    | 8.2    |
| Pohnpei| 8.7    | 8.9    | 8.8    | 10.0   | 10.7   | 12.6   | 11.8   | 12.6   | 16.9   | 14.1   |
| Yap    | 9.9    | 10.2   | 6.9    | 6.8    | 8.4    | 11.3   | 9.0    | 14.3   | 19.9   | 15.4   |

| **National and State Governments** |        |        |        |        |        |        |        |        |        |        |
| FSM    | 30.0   | 30.2   | 30.8   | 30.3   | 30.1   | 29.7   | 29.0   | 28.8   | 29.5   |        |
| Chuuk  | 28.2   | 28.1   | 29.8   | 27.2   | 24.7   | 25.2   | 25.2   | 25.2   | 23.2   | 23.8   |
| Kosrae | 41.7   | 42.9   | 43.2   | 42.9   | 39.1   | 35.2   | 34.8   | 31.9   | 29.2   | 34.2   |
| Pohnpei| 33.8   | 32.5   | 32.2   | 30.6   | 30.0   | 29.8   | 28.5   | 27.2   | 26.3   | 26.8   |
| Yap    | 19.5   | 20.5   | 22.5   | 21.7   | 22.5   | 21.3   | 22.2   | 21.3   | 19.6   | 21.1   |

− = negative, FSM = Federated States of Micronesia, FY = fiscal year, GDP = gross domestic product.

### Appendix 2

#### Table A2.10: Federated States of Micronesia: Nominal GDP by Institutions

(2004 constant prices, $ million)

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- = negative, FSM = Federated States of Micronesia, FY = fiscal year, GDP = gross domestic product.

Source: SBOC estimates provided in Graduate School USA, Pacific Islands Training Initiative. 2014. FSM Fiscal Year 2013 Statistical Appendixes.
Table A2.11: Federated States of Micronesia: Total Employment and Employment by Institutions  
(individuals)

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