FISCAL ANALYSIS AND IMPACT OF REFORMS
(Republic of the Marshall Islands: Public Sector Program)

A. The State of the Budget

1. The annual budget in the Republic of the Marshall Islands (RMI) is prepared on a cash-flow basis. All inflows, including grants, are treated as income and outlays itemized as either (i) general, (ii) special, (iii) capital, or (iv) debt service. All sources of funds (Table 1) are matched by an appropriation by the Nitijela (the Parliament), including financing items (notably contributions to the Compact Trust Fund) and access payments made by the United States (US) Government to Kwajalein landowners (the US operates a military facility on Kwajalein). Much of both the recurrent (general and special) and capital budgets have historically been funded from external sources. The Government has complete discretion only over the general fund, both in terms of expenditure and revenues. Income taxes, import duties, and gross revenue tax are the main revenue sources for this fund. Almost all General Fund expenditure is recurrent expenditure. Government financial statistics consistent with International Monetary Fund standards are prepared.

Table 1: Funding Sources

Funding Source	$ million		
	FY08	FY09	FY10
United States[a]	82.8	86.0	88.8
Compact	68.2	71.9	70.3
Special Revenue Funds	7.3	6.8	6.6
Federal Grants	7.3	7.3	11.8
Other foreign grants	12.8	5.3	14.0
Republic of the Marshall Islands (General Fund)	35.0	33.2	34.7

FY = fiscal year.
[a] US funding includes some financing items and payments to citizens that are not included in Government revenue.
Source: Ministry of Finance.

2. Most US assistance is provided under an amended Compact of Free Association between the US and the RMI. The initial Compact of Free Association came into effect in 1986. Under the Compact, the US was authorized to provide federal programs, such as grants, services, technical assistance, and loans. The US also provided a wide range of services including health care, education, telecommunications, training, aviation, disaster relief, postal, and weather services.[1] The first Compact ended in Fiscal Year (FY) 2001, and after lengthy negotiations an amended Compact was signed in 2004. The amended Compact introduced a new fiscal framework designed to raise the development impact of the US grants. The US grants continue to fund the large majority of government expenditure. Grants were earmarked to sectors; infrastructure was allocated 30 to 50% with the remainder allocated for education, health care, environment, capacity building, and private sector development.

3. A Compact Trust Fund (CTF) was also established under the amended Compact of Free Association. The main purpose of the CTF is to create an income stream to replace the US grants when the amended Compact agreement ends in 2023. The CTF is to be funded through a combination of US grants and RMI contributions. To reach target levels, sustained budget

[1] The experience under the first Compact is documented in US General Accounting Office. 2002. *Foreign Assistance Effectiveness and Accountability Problems Common in US Programs to Assist Two Micronesian Nations*. Report to Congressional Requesters. Washington D.C. (January).

surpluses are required. The budget has, however been in deficit in most years of the amended Compact (Table 1). This, combined with the adverse impact of the global financial crisis on the value of international equities held by the CTF, has resulted in the CTF falling short of the level required to ensure it can replace US Compact grants in 2024.

4. The 2008 and 2009 budget outcomes were aggravated by a weak economy and exemptions provided to food and fuel to lessen the effect of high international commodity prices. High international commodity prices resulted in inflation averaging 14.8% in 2008 and 9.6% in 2009, and resulted in a declaration of a National Economic Emergency in July 2008. During the period of high prices, the government had difficulty in paying vendors and creditors and salaries. It was forced to adopt ad hoc measures to cover short-term and unforeseen obligations, notably large cash advances paid to the Marshall Energy Company (MEC) for fuel purchases.

5. In addition to these cyclical problems, the budget suffers a number of structural weaknesses.[2] On the expenditure side, the ratio of wages and salaries to GDP is very high by international standards, having risen in recent years as past efforts to restructure the civil service unwound. The Budget Statement for the FY2008 Budget Statement identified the contribution played by the commencement new programs (e.g., the Ministry of Education kindergarten program in FY2005). However, the statement also recognized that the growth in expenditure was not sustainable and extra effort is needed to restrain employment and wage growth.[3] Government subsidies to state-owned enterprises (SOEs) are high (at around $7 million or 5% of GDP annually) and substantial other subsidies are paid. Notably, very generous subsidies are provided to landowners that have equipment and facilities of the Marshalls Energy Company on their land. Overall expenditure on capital and repairs and maintenance has been too low, displaced by high expenditure on wages and salaries and other items.

6. The revenue performance has been weak because of poor tax design (e.g., the tax base is too narrow) and weaknesses in administration that have contributed to very high non-compliance. Non-compliance has been estimated at 30-40% of tax collections, and result in an annual revenue loss of around 6% of GDP. Studies have identified the economic inefficiencies imposed by the tax system (e.g., the cascading effect of the gross revenue tax) and the inequities arising from a highly regressive tax structure (i.e., the average tax rate is lower at higher income levels).

B. Public Debt

7. The Government issued bonds in the early 1990s that were guaranteed by future inflows from the Compact, in effect borrowing against future income. The capital raised through bond sales did not deliver the hoped for strong returns. Furthermore, the Government provided guarantees to loans made by the SOEs, some of which was on commercial or near commercial terms. This SOE debt represents a contingent liability to the Government. High levels of loans and contingent liabilities had, by the late 1990s, led to an unsustainable debt position.

8. In FY1999 external debt was estimated at $98 million, equivalent to 102% of GDP. This had been reduced to $91 million by FY2004, the equivalent of 83% of GDP. Debt servicing was 18% of goods and services exports in FY2004, well below the 347% of FY1997.

---

[2] Fiscal performance is reviewed in the Pacific Islands Training Initiative. 2009. *RMI Fiscal Year 2008 Economic Review Summary Document.* August (Honolulu) and the International Monetary Fund's Article IV Consultation Staff Reports (available at www.imf.org). The latest assessment is presented in IMF. 2009. *Republic of the Marshall Islands – 2009 Article IV Consultation, Concluding Statement of the IMF Mission, Washington DC.*

[3] Comprehensive Adjustment Program Advisory Group. 2009. *Final Report.* Majuro (September).

Table 2: Summary of Government Accounts

Item	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09e	FY10p
A. Ratio to GDP (%)											
Revenue and grants	66.2	71.3	64.6	65.6	57.1	70.9	74.8	71.6	70.4	67.9	66.1
Revenue	21.8	20.6	22.3	22.6	25.1	25.6	25.1	25.5	25.7	24.0	24.5
Tax revenue	15.2	16.0	16.3	18.2	16.8	17.6	17.3	17.9	17.1	15.2	16.2
Income	7.8	8.4	7.8	9.5	7.9	7.9	7.7	7.4	7.2		
Gross revenue tax	2.9	3.3	2.9	2.7	3.0	2.8	3.3	3.9	3.8		
Imports	4.0	3.9	5.1	5.5	5.0	6.4	5.9	6.2	5.7		
Others	0.5	0.4	0.5	0.5	0.9	0.5	0.4	0.4	0.4		
Nontax revenue	6.6	4.6	6.0	4.4	8.2	8.1	7.8	7.6	8.5	8.8	8.3
Grants	44.4	50.7	42.3	43.0	32.0	45.3	49.7	46.1	44.7	43.9	41.6
Total expenditure	58.1	63.0	59.3	54.6	58.4	74.2	73.3	71.4	70.7	68.1	64.9
Current expenditure	47.3	46.1	45.4	43.8	50.0	55.9	54.1	54.4	58.5	54.4	51.2
Wages and salaries	15.5	16.3	17.4	20.1	22.6	23.7	23.6	22.2	22.5	22.5	22.3
Goods and services	18.0	15.6	18.1	17.2	20.1	22.5	22.7	21.0	22.4	22.9	18.0
Interest payments	1.8	1.3	0.5	0.7	0.6	0.7	0.6	0.6	0.9	0.8	0.8
Subsidies and transfers	12.0	12.9	9.4	5.8	6.7	9.0	7.2	10.6	12.7	8.2	10.1
Capital expenditure	10.8	16.9	13.9	10.8	8.4	18.3	19.2	17.0	12.2	13.7	13.7
Overall balance	8.1	8.3	5.3	11.0	(1.3)	(3.3)	1.5	0.2	(0.3)	(0.2)	1.2
B. Real value (US$ million, deflated by RMI consumer price index)											
Revenue and grants	73.5	79.7	76.8	82.8	74.2	92.7	96.8	94.4	81.4	78.5	76.8
Revenue	24.2	23.0	26.5	28.5	32.6	33.5	32.5	33.6	29.7	27.7	28.4
Tax revenue	16.9	17.9	19.4	22.9	21.9	22.9	22.5	23.6	19.9	17.5	18.8
Nontax revenue	7.3	5.1	7.1	5.6	10.7	10.6	10.0	10.0	9.8	10.2	9.6
Grants	49.3	56.7	50.3	54.3	41.6	59.2	64.3	60.8	51.7	50.8	48.4
Total expenditure	64.5	70.4	70.2	69.0	76.0	96.9	95.0	94.1	81.7	78.8	75.6
Current expenditure	52.5	51.5	53.8	55.3	65.1	73.0	70.1	71.7	67.6	62.9	59.6
Wages and salaries	17.2	18.2	20.7	25.4	29.4	30.9	30.5	29.3	26.0	26.0	26.0
Other items	35.3	33.3	33.1	29.9	35.7	42.1	39.6	42.4	41.6	36.9	33.6
Capital expenditure	12.0	18.9	16.4	13.7	10.9	23.9	24.9	22.4	14.1	15.9	16.0
Overall balance	9.0	9.3	6.6	13.8	(1.8)	(4.2)	1.8	0.3	(0.3)	(0.3)	1.2

e = estimate, FY = Fiscal Year, GDP = gross domestic product, p = projected, RMI = Republic of the Marshall Islands.
Source: Asian Development Bank estimates based on Economic Policy, Planning and Statistics Office. 2009. RMI Economic Statistics Tables, August (Majuro) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands:* Public Information Notice (PIN) No. 10/30. Washington D.C. (February).

9. The fall in debt servicing costs was achieved by the liquidation of the last of the bonds it issued in the 1990s and switching away from commercial debt to concessional debt, principally from the Asian Development Bank. Debt-servicing costs have recently risen somewhat as the grace periods on a number of the concessional loans have expired.

10. As at end FY2009, RMI had external public debt (government and government-guaranteed debt only) stock of $94.3 million, the equivalent of 61.7% of GDP. The net present value of the debt is estimated at 35.1% of GDP. Most of the existing public debt is on concessional terms (40% of the GDP to the ADB), with other major lenders being the US Rural Utility Service and the Bank of Guam.

11. Offsetting the debt are assets held in the CTF. In January 2008, the CTF balance was $88 million, but it had fallen to $65 million by March 2009. The CTF has since begun to recover and with the benefit of additional deposits stood at $104 million as of January 2010.[4]

C. Fiscal Sustainability

12. Table 3 highlights the consequences of inaction to correct RMI's fiscal imbalances. Under a business-as-usual situation, the scheduled decline in US grants is projected to widen the budget deficit to 4.5% of GDP in FY2015. The deficit would be even higher if the recent compression in expenditure on essential goods and services and capital expenditure were unwound and expenditure on these items rose.

Table 3: Projections under business-as-usual (ratio to GDP, %)

Item	**Estimates**		**Projections**				
	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Revenue and grants	67.9	66.1	64.8	63.4	62.2	61.1	60.1
Revenue	24.0	24.5	24.5	24.5	24.5	24.5	24.5
Tax revenue	15.2	16.2	16.2	16.2	16.2	16.2	16.2
Nontax revenue	8.8	8.3	8.3	8.3	8.3	8.3	8.3
Grants	43.9	41.6	40.3	39.0	37.7	36.7	35.6
Total expenditure	68.1	64.9	64.6	64.6	64.6	64.5	64.5
Recurrent expenditure	54.4	51.2	50.9	50.9	50.8	50.8	50.8
Wages and salaries	22.5	22.3	22.3	22.3	22.3	22.3	22.3
Goods and services	22.9	18.0	18.0	18.0	18.0	18.0	18.0
Interest payments	0.8	0.8	0.5	0.5	0.5	0.4	0.4
Subsidies and transfers	8.2	10.1	10.1	10.1	10.1	10.1	10.1
Capital expenditure	13.7	13.7	13.7	13.7	13.7	13.7	13.7
Overall balance	**-0.2**	**1.2**	**0.2**	**-1.2**	**-2.4**	**-3.4**	**-4.4**

FY = Fiscal Year, GDP = gross domestic product
A business as usual is defined as the estimated FY2010 outcome adjusted for the scheduled decline in US Compact grants and interest payments.
Source: Asian Development Bank estimates based on Economic Policy, Planning and Statistical Office. 2009. RMI Economic Statistics Tables, August (Majuro) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands:* Public Information Notice (PIN) No. 10/30. Washington D.C. (February).

13. The International Monetary Fund (IMF) has projected the longer term consequences of a scenario in which some fiscal correction is undertaken. Under a baseline scenario prepared by

[4] President of RMI. 2010. State of the Nation - 31st Constitutional Regular Session. January (Majuro) (available at http://www.rmigovernment.org/speeches_detail.jsp?docid=41.

the IMF, a fiscal surplus of about 1.5% of GDP, close to the estimated outcome for FY2010, was assumed to be maintained over the long term.[5] GDP growth was assumed to gradually decelerate to 1.2% as foreign grant assistance declined while private sector growth was assumed to remain sluggish. The rate of return on the CTF in 2009 was estimated to be about 9.4%, and projected to stay at this level in 2010 and decline to 6% per annum thereafter. Compact grants were calculated to reach $45.3 million in 2023. Given the terms of the Compact Agreement and without additional donations, the CTF's investment earnings were projected to be only $37 million in 2024. In order to preserve the real value of the fund, the RMI government would only be able to withdraw $23.3 million. This would leave a shortfall in funding of $22 million in 2024 ($16 million in 2009 prices, or 9% of GDP). Therefore, in the baseline scenario, the RMI government would either need to erode the real value of the CTF from 2024 or would face a large budget shortfall.

14. The IMF also prepared estimates of the fiscal adjustment required to ensure the CTF could provide the income stream large enough to replace the Compact grants without, as required under the Trust Fund agreement, eroding the real value of the assets. This is defined as a sustainable fiscal position. Under this alternative scenario of fiscal sustainability, it was found the government would need to gradually shift public finances into surplus (by about 1.0% of GDP each year) and channel the generated savings into the CTF. This would require a budget surplus of around 5.0% of GDP in FY2015 that would be maintained thereafter. Over the medium-term, it was assumed that roughly half of the adjustment would come from tax revenues and the other half from reductions in current expenditures. Under the scenario, structural reforms were assumed to boost real economic growth to 2%.

15. In its 2009 Article IV consultation, the IMF underscored the need to begin the fiscal consolidation process in 2010 by targeting a sufficiently large fiscal surplus, with a view to increasing savings in the CTF. It was emphasised that given a significant revenue gap projected for 2024, it will be important to sustain a large fiscal adjustment over time. In this regard, the IMF welcomed the Government's intention to develop a medium-term comprehensive adjustment plan, combining expenditure and revenue reform proposals to generate lasting fiscal surpluses. The IMF suggested that consolidation begin with cuts to the public wage bill, elimination of untargeted electricity and housing allowances, and adjustment of electricity tariffs to cost-recovery levels. The IMF also encouraged the Government to launch the proposed comprehensive tax reform, focusing on replacing the general revenue tax with a net profit tax, introducing a consumption tax, reforming the income tax, and unifying tax administrations.

16. The IMF stressed the importance of the complementary pursuit of a growth path consistent with domestic and external stability through structural reforms aimed at fostering private sector growth and competitiveness. Reform of state-owned enterprises was identified as a key priority so as to improve electricity and telecommunication services, while scaling back the operations of those involved in commercial activities. Wage and price flexibility was identified as important to helping maintain external stability in the context of dollarization.

[5] IMF. 2009. *Republic of Marshall Islands—2009 Article IV Consultation, Concluding Statement of the IMF Mission*. Washington D.C. (November) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands*. Public Information Notice (PIN) No. 10/30. Washington D.C. (February).