ECONOMIC AND FINANCIAL ANALYSES

A. Background

1. Public financial management (PFM) and operations of state-owned enterprises (SOEs) in the Republic of the Marshall Islands (RMI) are among the weakest in the Pacific. As such, wasted resources due to inefficiencies in public spending and service delivery are likely to be substantial. Further, government subsidies to the RMI's SOEs averaged the equivalent of 4.1% of gross domestic product (GDP) over fiscal year (FY)2004–FY2015. This is significantly higher than in comparator North Pacific economies, where subsidies to SOEs averaged the equivalent of 0.4% of GDP (in the Federated States of Micronesia), and 0.8% (in Palau). Further, the burden of SOE subsidies in the RMI appears to be increasing, reaching a high of $11.5 million (6.4% of GDP) in FY2015. Expenditures on SOE subsidies exceeded the level of capital expenditures for 4 consecutive years. Sizeable spending efficiency gains appear to be achievable through targeted PFM and SOE management reforms, which will free scarce fiscal resources. These resources can then be channeled toward more productive expenditures, including on essential social services such as health and education.

B. The Project

2. The proposed project is expected to strengthen the institutional capacity of the RMI Ministry of Finance (MOF) to implement the government's PFM Reform Roadmap, and SOE reforms to reduce the fiscal burden from subsidies. To facilitate the implementation of the Roadmap, a Reform Coordination Unit (RCU) will be established, to focus on the following core functions: public finance, financial management, and human resources.[1]

3. The government aims to reduce overall SOE subsidies while ensuring that any remaining subsidies are directed to fund legitimate and specific community service obligations (CSOs). This first requires identifying and estimating the cost of legitimate CSOs, particularly for the country's largest SOEs. The government can then determine to what degree subsidies fund legitimate CSOs—versus subsidies that are instead drained by SOE inefficiencies—which will be a first step towards streamlining subsidies to match public service delivery costs. Limiting SOE subsidies to CSOs will strengthen discipline on SOEs, help equalize competition with commercially viable businesses, and improve the environment for private sector growth.[2]

C. Proxy Cost–Benefit Analysis[3]

4. The project's main direct benefits are expected to be derived from the effective use of fiscal space that will be generated from a sustained reduction in SOE subsidies, when CSOs are fully identified and their costs determined, and inefficiencies eliminated. The resulting increased fiscal space is then assumed to be channeled to more productive uses (e.g., additional resources for essential government services such as health and education, which should contribute to

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[1] The functions have been selected based on discussions with the government and development partners. The World Bank plans to finance a $5 million grant project in 2018 that will focus on replacing *4Gov*, and updating related business processes. Procurement capacity building is also expected to be undertaken by the World Bank.

[2] The International Monetary Fund (IMF) has also highlighted that clarifying community service obligations of SOEs and establishing a centralized monitoring unit, building on the legislation of the SOE Act, will be important. IMF. 2016. *Republic of the Marshall Islands: 2016 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Republic of the Marshall Islands.* Country Report No. 16/260. Washington, DC.

[3] The proposed project involves technical assistance rather than investment, and a standard cost–benefit analysis is therefore not applicable.

steady gains in labor productivity). More public resources can also be channeled to ensuring sufficient funding of annual operations and maintenance of infrastructure assets, to preserve and prolong their productivity-enhancing benefits. This analysis further assumes that:

(i) Due to reforms, SOE subsidies in the RMI are gradually reduced to generate fiscal space equivalent to 0.5% of GDP by the end of FY2020.[4]
(ii) Increased fiscal space from public expenditure efficiency gains are maintained until at least FY2022.[5]
(iii) Given the country's high import dependence, fiscal multipliers—even with a more efficient public expenditure mix resulting from the project—are relatively small (about 0.5).[6]

5. Under these assumptions, project benefits can be estimated to total $5.1 million, inclusive of $3.4 million in increased fiscal space and $1.7 million derived from multiplier effects on the broader economy. Against a cost of $2.3 million, the project-related benefit–cost ratio is estimated at 2.2:1.0 (Table).

Table: Estimated Benefit–Cost Ratio for the Project

Cost ($ million)	Benefit ($ million)	Benefit–Cost Ratio
2.3	3.4 *(increased fiscal space)*	1.5
	1.7 *(multiplier effects on GDP)*	0.7

GDP = gross domestic product.
Source: Asian Development Bank.

6. This estimate excludes other efficiency gains in government expenditure through PFM improvements that are more difficult to quantify, including improvements in the strategic allocation of scarce government resources by strengthening linkages between multi-year sectoral plans and annual budgets. For example, PFM reforms will facilitate development of a medium-term budget framework that will support better public investment planning. Budget execution is also seen to improve, guided by more complete, granular, and up-to-date information on within-year progress on spending in priority sectors. Further, fiscal discipline will also be promoted through improved internal controls, cashflow planning, and commitment controls, as well as by external audits and the wider availability of information on the state of public finances. PFM reforms can also be expected to stimulate revenue mobilization with system and process improvements in areas such as taxpayer registration, tax administration and compliance, and broader revenue management.

7. Through a combination of greater public revenue mobilization and efficiency gains in terms of expenditures, PFM reforms can help generate much-needed fiscal space that can be redirected to more productive uses. Such rebalancing will boost the economic stimulus derived from

[4] This will reduce SOE subsidies in the RMI to the equivalent of 5.9% of GDP—a conservative scenario given that SOE subsidies in comparator North Pacific economies of the Federated States of Micronesia and Palau are each below 1.0% of GDP.

[5] Although capacity-building measures are built into the project design to promote longer-term sustainability, it is conservatively assumed here that reductions in SOE subsidies are sustained for a minimum of 5 years. This period also coincides with the expected completion of parallel World Bank support for PFM reforms in the RMI.

[6] ADB analysis suggests that fiscal multipliers for Pacific comparators are in the order of 0.9 for Fiji (which is less dependent on imports), and likely greater than 0.5 for a smaller economy (e.g., Tonga). ADB. 2009. *Taking the Helm: A Policy Brief on a Response to the Global Economic Crisis.* Manila.

government expenditure and help raise the RMI's overall growth prospects. The project is therefore considered an economically beneficial activity, particularly given potentially large longer-term spillover effects on broader economic growth and social welfare from improvements in the quality, efficiency, and composition of public expenditure.

8. The sustainability of reform benefits will be ensured through capacity building measures undertaken by the RCU which will work with staff from the MOF and line agencies. Knowledge and skills-transfer in crucial areas (e.g., CSO identification and cost estimation, and medium-term budgeting) will be priorities. Should post-project assessments conclude that follow-on capacity building activities will be necessary, these can be jointly supported, in coordination with other development partners engaged in PFM reforms in the RMI.