SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT[1]

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Summary.** As is true of other small island and atoll economies, the Republic of the Marshall Islands (RMI) faces significant challenges stemming from the country's geographical remoteness and dispersion that limit economic opportunities. Exposure to external shocks—both climatic and economic, particularly with the RMI's heavy reliance on external development assistance—compounds economic fragility. Economic provisions under the Compact of Free Association with the United States are slated to expire in 2023, and long-term fiscal sustainability amid substantially lower grant assistance inflows represents a major challenge. Weak public financial management (PFM) and inefficient operations of state-owned enterprises (SOEs) are critical constraints to strengthening the fiscal position and improving strategic resource allocation.

2. **Fiscal management.** A sharp rise in fishing license revenues following full implementation in 2012 of the vessel day scheme under the Parties to the Nauru Agreement has helped boost government revenues.[2] From an average of $2.0 million—or 1.2% of gross domestic product (GDP)—during FY 2008–FY2011, fishing license revenues rose almost fivefold to an average of $9.6 million (5.3% of GDP) per year during FY2012–FY2015. Although this shift toward higher fishing license revenues is seen to be structural and therefore likely sustainable over the longer-term, spending pressures have also increased in parallel. In particular, SOE subsidies reached a high of $11.5 million in FY2015, equivalent to 6.4% of GDP, and have exceeded government capital expenditures for 4 successive years. The RMI Compact Trust Fund, while broadly on track to achieve a target asset level sufficient to earn investment income that offsets expiring Compact grants after 2023, needs to be strengthened to safeguard against volatility in future asset returns. Latest assessments by the International Monetary Fund show that the RMI remains at a high risk of debt distress, with the ratio of public sector debt-to-GDP at about 50%.

3. **Public financial management.** A public expenditure and financial accountability (PEFA) assessment conducted in 2012 highlighted significant weaknesses the RMI's PFM framework (Table).[3] Foremost among these are issues relating to weak linkages between multi-year development planning and annual budget processes. Annual budget shares do not necessarily reflect government priorities as set out in sectoral strategies. The absence of a medium-term budget framework also contributes to weak public investment planning. In addition, budget reallocations frequently serve to further de-link policy priorities from sectoral allocations. Significant portions of government spending are also not reflected in annual budget documents, including, for example, annual expenditures from extra-budgetary funds (e.g., the Marshall Islands Social Security Administration and the Marshall Islands Health Fund). Weaknesses in internal controls, cashflow planning, and commitment controls produce constant pressure to keep spending within budgeted allocations. Accounting and reporting limitations hamper effective monitoring of in-year budget execution progress. Although the Public Accounts Committee provides some external scrutiny and audit—including through public hearings on audit reports—

[1] This summary is largely based on Asian Development Bank (ADB). 2016. *Finding Balance 2016: Benchmarking the Performance of State-Owned Enterprises in Island Countries*. Manila. and *Republic of the Marshall Islands: Public Financial Management Performance Report and Performance Indicators (Final Report)*. October 2012

[2] Information on the Parties to the Nauru Agreement's vessel day scheme is available in ADB. 2016. Managing rising fisheries license revenues in the Pacific. *Pacific Economic Monitor*. Manila.

[3] Republic of the Marshall Islands. 2012. *Public Financial Management Performance Report and Performance Indicators (Final Report*). Majuro.

follow-up actions on specific audit findings remain limited.[4] Other issues include weaknesses in tax administration and management, and the absence of a dedicated MOF website, which limits public access to fiscal information and hampers effective communication of PFM reforms to stakeholders. The MOF has experienced high turnover and loss of senior staff, and has received minimal technical support for *4Gov*—the RMI's financial management information system.

Table: Key Public Financial Management Challenges in the Marshall Islands

	Aggregate fiscal discipline	**Strategic resource allocation**	**Efficient service delivery**
Budget credibility	Weak expenditure controls undermine budget credibility and fiscal discipline. Lack of information on expenditure arrears.	Budgets not executed as planned across line ministries, undermining strategic resource allocation.	Frequent in-year changes to the budget that could potentially undermine spending efficiency.
Comprehensiveness and transparency	Budget documents are not comprehensive, with significant unreported operations. Limited active oversight of potential fiscal risks from public enterprises and sub-national governments.	Significant off-budget government spending (e.g. social security).	Limited availability of fiscal information to the public weakens the ability of stakeholders to verify if resources are being used efficiently.
Policy-based budgeting	Underlying fiscal policy objectives and macroeconomic assumptions are not explicit in the budget documents.	Weak links between the planning and budgeting processes (i.e. allocating resources to achieve government priorities as set out in costed and agreed sectoral expenditure strategies).	Limited policy information reduces the legislature's ability to review budgetary decisions. Lack of a medium-term budget contributes to weak planning, particularly for public investment.
Predictability and control in budget execution	Weaknesses in internal controls, cashflow planning, and commitment controls result in constant pressure to keep spending within budgeted allocations.	Frequent budget reallocations weaken links between policies and planned inter-sectoral budgetary allocations.	Weaknesses in internal controls, cashflow planning, and commitment controls result in constant pressure to keep spending within budgeted allocations.
Accounting, recording, reporting	Lack of systematic information on in-year budget execution reports.		
Effective external scrutiny and audit	Limited role for the legislature in examining fiscal policy prior to budget appropriations.	Limited scrutiny on the link between government policies and budgetary allocations.	Weak follow-up action to address audit findings.

Source: Republic of the Marshall Islands. 2012. *Public Financial Management Performance Report and Performance Indicators (Final Report*). Majuro.

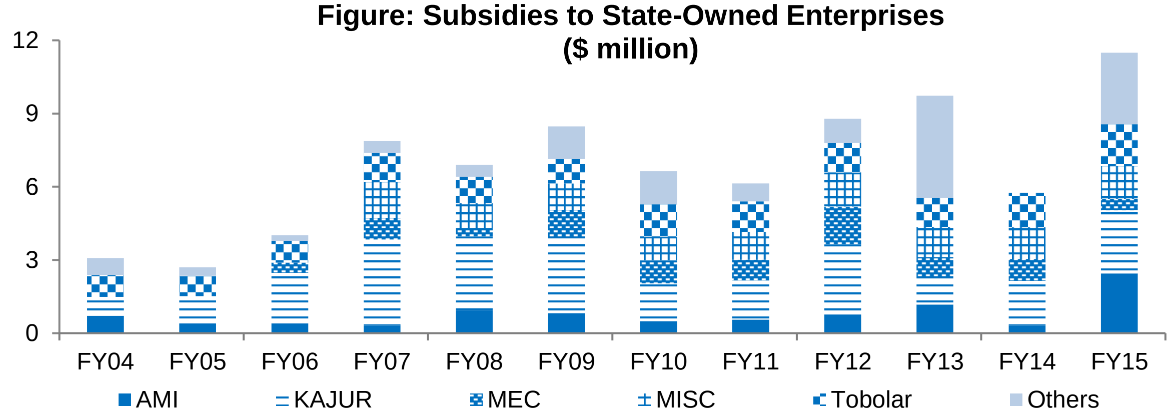
4. **State-owned enterprises.** Performance of the RMI's SOE sector is very weak, even in comparison with other Pacific economies. The RMI has 11 active SOEs; they operate in sectors where SOEs are common (e.g., utilities, transport, and telecommunications), but also in hotel administration and copra production. As of 2014, the SOE sector owns some 17%–20% of the total capital stock in the RMI economy, but contributes only about 5.3% to GDP.[5]

[4] The United States (US) Government Accountability Office conducts periodic reviews on the use and accountability of funds received through the Compact of Free Association. A 2013 report found that the RMI faces persistent challenges in accountability and non-compliance with US program requirements (e.g., accounting for equipment).

[5] This translates to a contribution of around 0.27%–0.31% to GDP for every 1% share of total fixed capital owned by SOEs in the RMI. By contrast, SOEs in Kiribati—the best performer in the sample—contribute 0.67% to GDP per 1% share in total fixed capital. Refer to ADB. 2016 (footnote 1).

5. SOEs in the RMI provide a range of public services with non-commercial objectives, while receiving significant government transfers and accessing discounted debt subsidized to fund community service obligations (CSOs). On average, government subsidies to SOEs during FY2004–FY2015 were the equivalent of 4.1% of GDP. Over this period, the recipients of the largest government subsidies were: (i) the Kwajalein Atoll Joint Utility Resources, the utility providing power, water, and sewerage services to the island community of Ebeye—the second largest urban center in the RMI; (ii) the Tobolar Copra Processing Authority, which is engaged in processing of copra, mostly from outer-island communities; (iii) Marshall Islands Shipping Corporation; (iv) Air Marshall Islands; and (v) Marshalls Energy Company (figure). Further, on average, SOEs have paid interest rates about 7.7% lower than prevailing commercial rates on their concessional borrowings over the last 5 years. The subsidized cost of borrowing by SOEs in the RMI is among the lowest in the Pacific. High annual fiscal contributions pose a significant burden that drain resources away from essential social services, including health and education. To illustrate, net transfers to SOEs have amounted to over a third of total public expenditure on health during FY2010–FY2014.

Figure: Subsidies to State-Owned Enterprises
($ million)



AMI = Air Marshall Islands, KAJUR = Kwajalein Atoll Joint Utility Resources, MEC = Marshalls Energy Company, MISC = Marshall Islands Shipping Corporation
Note: 'Others' include the Majuro Atoll Waste Company, Majuro Water and Sewer Company, Marshall Islands Port Authority, Marshall Islands Postal Service, Marshall Islands Resort, and National Telecommunications Authority.
Source: Republic of the Marshall Islands Fiscal Year 2015 Economic Review.

6. Reducing the fiscal burden from SOE operations is critical to overall PFM reforms. However, this should proceed in a manner that safeguards the sustainable delivery of CSOs. An important first step will involve a detailed estimation of the legitimate costs of delivering CSOs as mandated for respective SOEs. Clear identification and proper assessment of CSO costs will help in determining what portion of subsidies effectively finance SOE inefficiencies.

2. Government's Sector Strategy

7. **Public Financial Management Reform Roadmap.** In response to the 2012 PEFA results, the government developed the PFM Reform Roadmap 2014–2016, which consists of 30 reform components, including nonsystem measures for strengthening coordination and oversight, as well as capacity-building efforts. The Roadmap emphasizes: (i) coordination of development partner assistance for PFM reforms; (ii) improving accounting and reporting practices; (iii) clarifying the budgetary framework; (iv) strengthening procurement; (v) enhancing human resources, including payroll systems; (vi) promoting improved fiscal management, including of tax and non-tax revenue, debt, and contingent liabilities; and (vii) monitoring SOEs. The Roadmap was endorsed by the

Cabinet in December 2015. A PFM Reform Steering Committee was established in March 2016 to provide high-level management chaired by the chief secretary. The MOF leads coordination efforts to implement the Roadmap.

8. However, the Roadmap lacks systematic prioritization and effectively remains a wish list, with limited implementation progress amid high staff turnover and insufficient capacity. Also, there is insufficient understanding of the FMIS system, except among staff sufficiently trained in information technology to operate *4Gov* but who often lack the non-systems financial knowledge required to generate usable reports. Coordination among internal government agencies on PFM issues is weak. Agencies outside the MOF lack full understanding of their financial reporting responsibilities and are therefore often unable to comply with core financial regulations. There is likewise room to improve development partner coordination in supporting PFM reforms.

9. **State-Owned Enterprises Act.** In October 2015, the Marshall Islands adopted an SOE Act to strengthen corporate governance and monitoring of SOEs. The act was developed with support from ADB through its Private Sector Development Initiative (PSDI), and provides for SOE commercialization while establishing a sound corporate governance framework. However, this has subsequently been weakened by a 2016 amendment that allows elected officials to remain on SOE boards. The PSDI TA is supporting the implementation of the SOE Act, focusing on improving transparency, accountability, and financial disclosure. Although the MOF is responsible for implementing the act, this has been constrained by capacity limitations and insufficient understanding of its SOE monitoring role. Line ministers and senior managers from SOEs are also often unable to meet the reporting and accountability requirements under the act. The absence of a centralized SOE-monitoring unit within the MOF diffuses responsibility and limits efforts to enforce fiscal discipline.

3. ADB Sector Experience and Assistance Program

10. The Pacific Approach 2016–2020 serves as ADB's country partnership strategy for the RMI, and supports: (i) PFM improvements to achieve greater resilience to external economic and financial shocks, and (ii) increased financial efficiency of SOEs to support a more conducive environment for business.[6] The proposed project grant is included in ADB's lending pipeline for 2017.[7] ADB's approach to engaging in fragile and conflict-affected situations, including the RMI, further recognizes the importance of institutional strengthening and capacity building.[8]

11. The project builds on previous ADB support to the RMI for PFM and SOE reforms. Through two subprograms under the Public Sector Program, ADB assisted the RMI in adopting and implementing reform plans to improve the performance of selected SOEs, completing a public sector workforce audit and planning exercise, and achieving specific expenditure targets.[9] Country TA has also been provided to support implementation of the government's national development plan. Further, regional TA through the PSDI has helped the RMI improve governance within SOEs and develop SOE policy and legislation, develop a fiscal management model, and periodically clear audit backlogs. With an in-country presence established through a national development coordination officer, ADB provides ongoing accounting support to the MOF.

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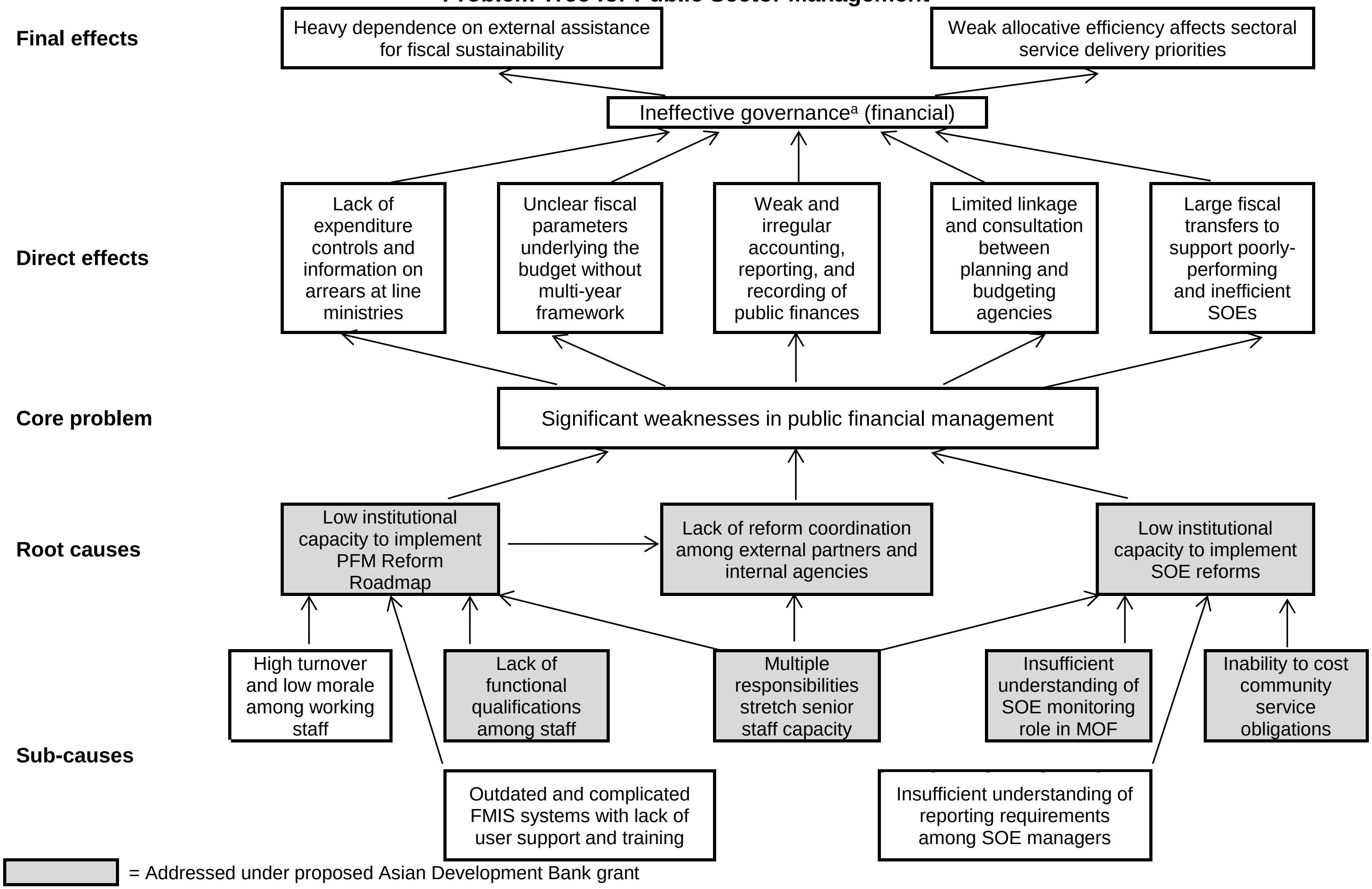
[6] ADB. 2016. *Pacific Approach 2016–2020.* Manila.
[7] ADB. 2016. *Marshall Islands 2017–2019. Country Operations Business Plan*. Manila.
[8] ADB. 2013. *Operational Plan for Enhancing ADB's Effectiveness in Fragile and Conflict-Affected Situations.* Manila.
[9] ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Program Cluster, Loan for Subprogram 1, and Technical Assistance Grant to the Republic of the Marshall Islands for the Public Sector Program.* Manila; and ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan for Subprogram 2 to the Republic of the Marshall Islands for the Public Sector Program.* Manila.

Problem Tree for Public Sector Management



FMIS = Financial Management and Information System; MOF = Ministry of Finance; PFM = public financial management, SOE = state-owned enterprise.

[a] Achieving effective governance is a cross-cutting theme of: Government of the Marshall Islands. 2014. *National Strategic Plan 2015–2017*. Majuro.

Source: Asian Development Bank.