ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 43321
July 2010

Proposed Program Cluster, Loan for Subprogram 1, and Technical Assistance Grant
Republic of the Marshall Islands: Public Sector Program

Asian Development Bank

CURRENCY EQUIVALENTS

The currency unit of the Republic of the Marshall Islands is the US dollar.

ABBREVIATIONS

ADB	–	Asian Development Bank
CAP	–	Comprehensive Adjustment Program
CTF	–	compact trust fund
FY	–	fiscal year
GDP	–	gross domestic product
IMF	–	International Monetary Fund
JFPR	–	Japan Fund for Poverty Reduction
MEC	–	Marshalls Energy Company
MOF	–	Ministry of Finance
PARD	–	Pacific Department
RMI	–	Republic of the Marshall Islands
SOE	–	state-owned enterprise
TA	–	technical assistance
TRAM	–	Tax and Revenue Reform and Modernization
US	–	United States

NOTES

(i) The fiscal year (FY) of the Government of the Marshall Islands and its agencies ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2009 ends on 30 September 2009.

(ii) In this report, "$" refers to US dollars unless otherwise stated.

Vice-President	C. L. Greenwood, Jr., Operations 2
Director General	R. Wihtol, Pacific Department (PARD)
Director	S. Ra, Pacific Operations Division, PARD
Team leaders	K. Nakamitsu, Education Specialist, PARD
	C. Sugden, Senior Economist, PARD
Team members	M. Davidovski, Senior Counsel, Office of the General Counsel
	H. Everett, Financial Sector Specialist (Public Finance), PARD
	A. Maxwell, Energy Specialist, PARD
	S. Pollard, Principal Economist, PARD
Peer reviewers	M. E. Khan, Principal Economist, Economics and Research Department
	S. Shrestha, Governance and Capacity Development Specialist, Regional and Sustainable Development Department (RSDD)
	P. Talbot, Principal Financial Sector Specialist, RSDD

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed program cluster for the Public Sector Program, and (ii) a proposed loan to the Republic of the Marshall Islands (RMI) for subprogram 1 of the Public Sector Program. The report describes proposed technical assistance (TA) for Supporting the Public Sector Program, and if the Board approves the proposed program cluster and loan for subprogram 1, I, acting under the authority delegated to me by the Board, will approve the TA.

II. THE PROGRAM

A. Rationale

2. The RMI economy relies heavily on government expenditure and, in turn, on the foreign grants that fund more than two-thirds of government expenditure.[1] Most foreign grants are provided by the United States (US), mainly under the amended Compact of Free Association. Increased foreign grants helped the economy grow at an average annual rate of 3.1% from FY2000 to FY2007. However, in FY2008, the economy contracted by 2.0% as high world food and fuel prices raised inflation to 14.8%, prompting the declaration of a state of national economic emergency. There was no economic growth in FY2009, and the outlook is for low growth over the medium term.[2] The subdued outlook reflects a scheduled decline in US Compact grants and deep structural weaknesses that constrain private sector development.

3. The Compact grants are on an annual decremental schedule that will continue until FY2023. The governments of the RMI and US are investing in a compact trust fund (CTF) that is intended to generate a revenue stream to replace US Compact grants in FY2024. Contributions from the RMI government have, however, fallen short because excessive recurrent expenditure and poor revenue performance have prevented the generation of the required fiscal surpluses.[3] The value of the CTF is now substantially below target, and the International Monetary Fund (IMF) has projected a revenue shortfall of 9% of gross domestic product (GDP) in FY2024.[4]

4. The RMI must make a concerted effort to increase its contributions to the CTF. An early, phased adjustment can minimize the economic and social cost, notably by avoiding the need for sharp cuts in public expenditure and the delivery of essential services when US Compact grants end. The IMF recommended that fiscal adjustment begin immediately to close the looming revenue gap and achieve a fiscal surplus of 5.0% of GDP by FY2015. Recommended adjustments include cutting the public wage bill; eliminating untargeted allowances; modernizing the public sector including state-owned enterprise (SOE) reform; and launching comprehensive tax reform.[5]

5. The government has initiated wide-ranging public sector reform and fiscal adjustment prepared through broad engagement with stakeholders. The Tax and Revenue Reform and Modernization (TRAM) Commission was established in July 2008, and this was followed by the formation, with Asian Development Bank (ADB) support, of the Comprehensive Adjustment

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1 Economic Analysis (Appendix 2).
2 Economic conditions are discussed in ADB. 2010. *Asian Development Outlook 2010*. Manila; ADB. *Pacific Economic Monitor*. various editions.
3 Fiscal Analysis and Impact of Reforms (Appendix 2).
4 International Monetary Fund Assessment Letter (Appendix 2).
5 IMF. 2009. *Republic of the Marshall Islands, 2009 Article IV Consultation,* Washington (the concluding statement of the IMF mission).

Program (CAP) Advisory Group in April 2009.[6] Drawing on advice from the IMF's Pacific Financial Technical Assistance Centre, the TRAM commission recommended wide-ranging tax reform to raise more revenue and reduce economic distortions arising from the poor design of the tax system.[7] The CAP Advisory Group identified ways to rationalize expenditure that could achieve annual fiscal savings of $4.0 million–$10.5 million within 3 years.[8] The proposed public sector reforms are critical for addressing the impediments to private-sector-led economic growth that arise from the large and inefficient public sector (footnote 1).

6. The CAP Advisory Group also urged SOE reform. The reforms have commenced with an emphasis on the Marshalls Energy Company (MEC), the country's largest SOE. The imperative is to reduce the risk to the budget posed by the SOE sector by transferring certain SOE activities to the private sector and making SOEs more efficient.[9] The MEC has developed a comprehensive recovery plan to ensure that its electricity business becomes profitable and financially stable and meets good service standards.[10] The RMI has recognized the need for similar reform initiatives in other poorly performing SOE monopolies.

7. The program supports the implementation of the recommendations of the TRAM commission and the CAP Advisory Group. It will initiate the adjustments required to achieve fiscal sustainability.[11] Under subprogram 1, policy actions have been designed and the implementation of immediate reform priorities has commenced. Subprogram 2 will largely complete the implementation of the policy actions. The five policy action areas are common to both subprograms and will progress concurrently under each.

8. The program is aligned with the RMI Country Operations Business Plan, 2010–2012 and *ADB's Pacific Approach, 2010–2014*.[12] The program also applies lessons from earlier ADB policy programs in the RMI and elsewhere in the Pacific, as well as ADB's approach to engaging with weakly performing countries, notably by (i) adopting a country-led set of policy actions developed in an open, participatory manner and at a pace in keeping with country practices and (ii) initiating long-term policy dialogue and providing targeted TA support.[13]

B. Impact and Outcome

9. The impact will be a more efficient and effective public sector. The outcome will be the achievement of fiscal sustainability. The program will be structured in two sequential subprograms.

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6 Fiscal Reforms and Impacts (Appendix 2). Support provided under ADB. 2009. *Technical Assistance to the Republic of the Marshall Islands for Responding to Economic Crisis*. Manila (TA 7336-RMI, $225,000, approved on 25 August).

7 Tax and Revenue Reform and Modernization Commission. 2010. *RMI: A Holistic Approach to Reforming the Tax System*. Majuro (submitted to the minister of finance in February); Pacific Financial Technical Assistance Centre. 2009. *Republic of the Marshall Islands: Reforming the Tax System*. Suva (aide-mémoire, September).

8 Comprehensive Adjustment Program Advisory Group. 2009. *Final Report.* Majuro (September).

9 State-Owned Enterprise Analysis (Appendix 2). Government subsidies to SOEs amount to 5% of GDP each year. In addition, cash advances have at times been required to ensure solvency. Most recently, the government advanced to the MEC $7.9 million (5.0% of GDP) in the 12 months to July 2009, placing heavy pressure on government cash flow.

10 Marshalls Energy Company Analysis (Appendix 2).

11 The program adopts the IMF definition of fiscal sustainability, in which the balance in the CTF is on track to provide a revenue stream that can replace US Compact grants in 2024.

12 ADB. 2010. *Country Operations Business Plan: Marshall Islands, 2010–2012*. Manila; ADB. 2009. *ADB's Pacific Approach, 2010–2014*. Manila.

13 ADB. 2009. *ADB Support for Public Sector Reforms in the Pacific: Enhance Results through Ownership, Capacity, and Continuity*. Manila; ADB's approach to fragile situations is outlined in ADB. 2007. *Achieving Development Effectiveness in Weakly Performing Countries*. Manila.

C. Outputs

10. **Output 1: Improved medium-term fiscal outlook.** Under subprogram 1, the cabinet endorsed budget targets for FY2011 and FY2012 that will bring budget outcomes in line with IMF recommendations.[14] The key target is a budget surplus large enough to fund RMI contributions to the CTF that average 1.5% of GDP per annum (approximately $2.5 million) in FY2011 and FY2012.[15] Complementary targets were set for the budget items, including civil servant wages and salaries, grants and transfers, capital expenditure, and tax revenue (Table 1). The cabinet also endorsed debt management guidelines for the government and SOEs. Subprogram 2 provides for the achievement of budget targets over FY2011 and FY2012 and an update of the targets for FY2013. The updates will include a target contribution to the CTF in FY2013 of at least 3.0% of GDP (approximately $5.2 million). The adoption of a public sector debt management strategy and fiscal responsibility legislation is also provided for under subprogram 2 as measures to continue fiscal adjustment.

Table 1: Subprogram 1 Budget Framework (% of GDP)

	Estimates		**Projections**[a]	
Item	FY2009	FY2010	FY2011	FY2012
Revenue and Grants	67.9	66.1	65.0	63.9
Revenue	24.0	24.5	24.6	25.0
Tax revenue	15.2	16.2	16.3	16.7
Nontax revenue	8.8	8.3	8.3	8.3
Grants	43.9	41.6	40.4	38.9
Total Expenditure	68.1	64.9	62.7	60.6
Recurrent expenditure	54.4	51.2	49.0	46.9
Wages and salaries	22.5	22.3	21.7	21.0
Goods and services	22.9	18.0	17.2	16.4
Interest payments	0.8	0.8	0.6	0.5
Subsidies and transfers	8.2	10.1	9.5	9.0
Capital expenditure[b]	13.7	13.7	13.7	13.7
Overall Balance	(0.2)	1.2	2.3	3.3
Memo Items:				
Amortization	0.8	1.2	1.4	1.3
Compact trust fund deposits	0.0	0.0	1.0	2.0

( ) = negative, FY = fiscal year, GDP = gross domestic product.

[a] Projections for FY2011 and FY2012 are to be adjusted for any difference in the revised estimate for FY2010 from that shown.

[b] This is the target minimum capital expenditure, which is expected to be higher than shown if recurrent expenditure is below target or revenue is above target.

Source: Asian Development Bank estimates based on data provided on 18 May 2010 from the Ministry of Finance.

11. The budget targets will be achieved through the actions of outputs 2 and 3, which will restrain recurrent expenditure and increase tax revenue (footnote 3). The government's contribution to the CTF will be from its own general fund and be in addition to the contributions from the US, which are off the RMI budget. The medium-term direction underlying the program is an increase in the budget surplus to 5.0% of GDP by FY2015, as recommended by the IMF.

[14] It was endorsed in 23 June 2010 with the RMI Cabinet Minutes 082.

[15] The budget surplus is to be defined based on the IMF's Government Financial Statistics standards.

12. **Output 2: Restraint of recurrent expenditure.** Under subprogram 1, the CAP Advisory Group prepared an independent review of public expenditure that encompassed the findings of work force audits in three major ministries: education, health, and public works. The cabinet endorsed the CAP Advisory Group report and the specific actions recommended by the group to restrain recurrent expenditure. These actions will be implemented in the FY2011 and FY2012 budgets. Subprogram 2 provides continued restraint of recurrent expenditure and extends work force audits to six more ministries.

13. The CAP Advisory Group presented a range of policy options across 13 reform areas. The program implements selected actions across these reform areas.[16] In FY2011, funding for 50 vacant positions in the civil service will be removed. Compensation paid to landowners for the MEC's access to their land will be reduced, and the government's administrative expenditures on, for example, housing leases and rental, electricity, water, communications, vehicles, fuel, and travel expenses will be reduced. In addition, there will be a freeze on the government's wage and salary bill and allowances paid to members of the Nitijela (Parliament) and public servants. The expenditure freeze on these items will reduce the real cost of recurrent expenditure over time. The reduction in recurrent costs will raise the cost efficiency of the government, and work force audits will guide efforts to raise the productivity of the civil service.

14. **Output 3: Increased tax revenue.** Under subprogram 1, the independent assessment of the tax system by the TRAM commission has been completed. The cabinet endorsed the commission's report and specific actions recommended by the commission to increase tax revenue, for implementation from FY2011. Subprogram 2 provides for continued tax modernization.

15. The TRAM commission recommended replacing an array of existing taxes with a modern tax regime that has higher revenue potential. The proposed new taxes are a consumption tax, an excise tax for certain goods (e.g., alcohol and fuel), a net profit tax for large businesses, and a modified wages and salaries tax. These new taxes would replace hotel taxes, import duties, various local taxes, and gross revenue taxes (except those on small businesses). The new taxes are designed to reduce distortions facing producers and consumers. The commission also recommended changes to the income tax (e.g., removing generous exemptions and adopting a tax-free threshold) to reduce regressive aspects of it and improve tax administration (e.g., unifying tax administration, improving tax audits, and harmonizing tax collection processes).

16. The initial priority under the program is to raise compliance through improved administration. These actions are expected to generate most of the additional tax revenue targeted under the program. The new taxes are to be implemented in a revenue-neutral manner for existing taxpayers. The medium-term target is to lift the ratio of taxes to GDP to 16.2% from 15.2% in FY2009, as recommended by the IMF.

17. **Output 4: Improved performance of SOEs.** Under subprogram 1, an assessment was conducted of the performance of the 11 major SOEs, and the cabinet endorsed good practice principles to guide the ongoing SOE reform. A comprehensive recovery plan was prepared for the MEC and endorsed by the MEC board, and implementation commenced. The cabinet and the MEC board endorsed debt restructuring for the MEC, and the MEC board endorsed the establishment of a maintenance account to hold funds set aside for maintenance. Subprogram 2

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[16] Fiscal Reforms and Impacts (Appendix 2).

provides for annual public reporting on SOE performance, the adoption of an SOE policy, the implementation of an SOE act, the continued implementation of the MEC comprehensive recovery plan, and the implementation of MEC's debt restructuring and maintenance account. Time-bound recovery plans are to be prepared under subprogram 2 for other SOEs at risk through the application of the good practice principles.

18. The SOE assessment examined the financial performance, constraints, and options for reform of the major SOEs.[17] The analysis highlighted risk from the SOE sector to the budget, noting the need for subsidies and, from time to time, urgent cash injections to ensure solvency. This assessment will be regularly updated during the program, including through participation in the update of ADB's Finding Balance reports in 2010 and 2011.[18] A more solid performance assessment system will be established through the SOE policy and SOE act that will be developed from the good practice principles. The good practice principles build on lessons from SOE reform in the Pacific and elsewhere. Notably, they emphasize the importance of a sound corporate governance framework, including ensuring clarity in strategic direction and the independence of SOE boards. The principles will underpin the development of an SOE policy and the preparation of an SOE act.

19. The MEC comprehensive recovery plan includes actions to (i) improve corporate governance through the reconstitution of the board, (ii) improve procurement and financial management, (iii) align tariffs to reflect costs, (iv) reduce system losses, (v) improve billings through prepaid metering and better collection, (vi) raise the efficiency of fuel usage, (vii) reduce nonessential expenditure, and (viii) overhaul the main generators and other major equipment (footnote 10).

20. MEC's debt restructuring has three elements: (i) replacing a sovereign-guaranteed loan from the Bank of Guam with a concessional loan from the government, (ii) deferring principal repayments on an existing loan from the Rural Utility Services of the US Department of Agriculture, and (iii) establishing a debt-servicing sinking fund. Counterpart funds generated by the proceeds of the proposed program loan will be onlent to the MEC, with most funds to be used to repay the Bank of Guam loan. Onlending will be at the actual concessional cost of funds and done under a subsidiary loan agreement with the Ministry of Finance (MOF). The interest and cash flow savings will be used to strengthen the financial position of the MEC and finance priority actions of the MEC comprehensive recovery plan. The subsidy implicit in the provision of the concessional loan will be recognized as part of the funding of community service obligations provided by the MEC. The debt servicing sinking fund will be controlled by MOF and accumulate funds set aside by the MEC to service its new loan from the government.

21. **Output 5: Stakeholder participation and consultation supported.** Public consultation was initiated under subprogram 1 to support the development of a country-led and broadly supported set of policy actions. This provided for consultation involving the public sector, development partners, the private sector, civil society, academia, and women's organizations. Public consultation will continue throughout the program. Notably, the stakeholder forum established under subprogram 1 will reflect public views and inputs to the program.

[17] State-Owned Enterprise Analysis (Appendix 2); B. Graham and L. Alik. 2010. *Revisiting the Marshall Islands Reform Agenda: A Review of 11 Public Enterprises and Options for Reform*. Majuro; ADB. 2009. *Technical Assistance to the Republic of the Marshall Islands for Responding to the Financial Crisis*. Manila (February).

[18] ADB. 2009. *Finding Balance: Making State-Owned Enterprises Work in Fiji Islands, Samoa and Tonga*. Manila.

D. Program Costs and Financing

22. The government has requested financial assistance in the form of a program cluster comprising two loans amounting to $14.5 million equivalent, $9.5 million equivalent for subprogram 1 and $5.0 million equivalent for subprogram 2. ADB will provide a loan in various currencies equivalent to $9.5 million for subprogram 1 from its Special Funds resources. The loan will have a 24-year term, including a grace period of 8 years, an interest rate of 1.0% per annum during the grace period and 1.5% per annum thereafter, and such other terms and conditions set forth in the draft loan agreement. The remaining costs of the program will be met by the government.

23. The government shall ensure that the counterpart funds generated from the proceeds of the loan will be onlent to the MEC to enable the repayment of its sovereign-guaranteed loan of $8.4 million from the Bank of Guam and the implementation of other reforms in the MEC comprehensive recovery plan. The MEC's cash flow will be improved, enabling the refurbishment of its generators. This will help ensure continuity of supply and, combined with other reforms, ensure the financial integrity of the MEC (footnote 10).

24. Loan size has been determined after due consideration of (i) the adjustment costs to be incurred by the MEC in refurbishing its major assets and achieving a sound financial position, (ii) the significance of the policy actions, and (iii) the program's alignment with the RMI country operations business plan, 2010–2012.[19]

E. Implementation Arrangements

25. The program will be provided as a cluster comprising two subprograms. A single tranche loan of $9.5 million equivalent will be disbursed under subprogram 1 when the government has met the conditions for effectiveness. The duration of subprogram 1 is from 1 April 2009 to 31 August 2010. Subprogram 2 will be presented for consideration and approval by ADB's Board of Directors depending on the progress achieved in implementing subprogram 1. Subprogram 2 is expected to be considered by the Board 18 months after the loan for subprogram 1 becomes effective.

26. MOF, as the executing agency, shall be responsible for (i) overseeing all policy, legal, and regulatory actions to be undertaken in connection with the program and (ii) ensuring that all policy reforms set out in the policy letter and policy matrix are duly carried out in a timely manner (Appendixes 3 and 4). MOF shall also be responsible for implementing the program cluster and the program, including reporting to ADB, administering and disbursing loan proceeds, and maintaining program records and accounts.

27. The government and ADB have agreed on a range of outcomes and output indicators to monitor program implementation and evaluate its impact (Appendix 1). MOF will (i) establish a performance evaluation system for the program within 4 months of loan effectiveness, which will be derived from the design and monitoring framework, policy letter, and policy matrix, and (ii) monitor and report to ADB every 6 months during the program on the implementation of policy actions and their impact on budget outcomes and SOE performance (including financial and performance indicators), in line with the program impact and outcome indicators agreed with the government.

[19] ADB. 2010. *Country Operations Business Plan: Marshall Islands, 2010–2012*. Manila.

28. ADB, in collaboration with MOF and other multilateral and bilateral agencies, will assess the program performance 6 months after loan effectiveness to review the outcome of subprogram 1 and initiate the preparation of subprogram 2.[20] This review will (i) evaluate the implementation of the policy reform measures under subprogram 1, (ii) assess impact, (iii) identify lessons learned, and (iv) outline reforms and assistance needed for sustained fiscal consolidation to enable the processing of subprogram 2.

29. The proceeds of the loan will be disbursed to the RMI as the borrower according to ADB's *Simplified Disbursement Procedures and Related Requirements for Program Loans*.[21] The proceeds will finance items produced and procured in ADB member countries and exclude items on the list of ineligible items and imports financed by other bilateral and multilateral sources.[22] Supporting import documentation will not be required if, during each year that loan proceeds are expected to be disbursed, the value of RMI imports minus imports from nonmember countries, ineligible imports, and imports financed under other official development assistance is greater than the amount expected to be disbursed during that year. Otherwise, import documentation under existing procedures will be required. Before the first withdrawal, the government will open or nominate a deposit account at a designated bank to receive the loan proceeds.

30. Implementation arrangements are summarized in Table 2.

Table 2: Implementation Arrangements

Aspects	**Arrangements**
Implementation period	From 1 April 2009 to 31 August 2013
Estimated program completion date	31 August 2013
Program management	
(i) Oversight body	Program steering committee: Ministry of Finance, Ministry of Public Works, Ministry of Resources and Development, and the Chief Secretary's Office
(ii) Executing and implementing agency	Ministry of Finance
Disbursement	The $14.5 million equivalent program cluster will be disbursed as two single tranche loans: $9.5 million equivalent for subprogram 1 and $5.0 million equivalent for subprogram 2.

Source: Asian Development Bank.

III. TECHNICAL ASSISTANCE

31. It is proposed that TA be approved together with the program to support its implementation. The impact and outcome of the TA are the same as those of the program. The TA is estimated to cost $700,000 equivalent, of which $600,000 equivalent will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-IV). The government will finance $100,000 equivalent in kind. MOF will be the executing agency in conjunction with the

[20] The development partners will hold a development partner coordination meeting in 2010 that will establish a common mechanism to provide ongoing support for the harmonized implementation of the program.
[21] ADB. 1998. *Simplified Disbursement Procedures and Related Requirements for Program Loans*. Manila.
[22] List of Ineligible Items (Appendix 2).

Public Service Commission and the MEC. The TA will be implemented together with the program from mid-2010 to 31 August 2013.[23]

32. The TA will be complemented by two proposed Japan Fund for Poverty Reduction (JFPR) grant projects to be administered by ADB, which will cover social safety nets, prepaid metering, refurbishment of generation equipment, and grid extension.[24] The proposed JFPR-funded project in the energy sector will support the MEC's reform initiatives to improve demand-side and supply-side efficiencies. Residents in Majuro will benefit from better access to reliable power and improved capacity provided by prepaid metering to reduce their power expenditure.[25]

33. The TA for Pacific Economic Management supports economic monitoring, analysis, and policy advice in Pacific developing member countries, including the RMI.[26] The TA focus is on macroeconomic management with an emphasis on fiscal and structural policy. The scope of assistance extends to revitalizing economic management systems, including support for the increased participation of stakeholders in economic management and policy.

34. The Pacific Private Sector Development Initiative supports Pacific developing member countries' coordination of private sector reforms, including through SOE reforms and assistance in developing capacity to implement public–private partnerships; reforms to the legal enabling environment for business, including the reform of company, insolvency, and trustee law; and improving access to financial services.[27]

35. Together with ADB, other development partners are providing substantial support to public sector reform in the RMI. With the proposed JFPR project on Improved Energy Supply for Poor Households, the US and ADB agree to work closely on installing prepaid meters through parallel implementation. The IMF's Pacific Financial Technical Assistance Centre will play a lead role in assisting the government's revenue reform. The Australian Agency for International Development will work closely with ADB to support public sector reform in the RMI. The European Union, Japan, and Taipei,China agreed to adopt a common approach with ADB and are exploring an opportunity for a formal partnership agreement. The World Bank will continue to provide technical support to improve the MEC's financial and technical management. In the spirit of development partner harmonization, all have agreed to form a joint program steering committee to support the RMI reform effort. ADB assistance will be provided in a manner that is harmonized and consistent with that of other partners.[28]

IV. DUE DILIGENCE

A. Economic and Financial

36. The primary gain from the program in the short to medium term will be the improved budgetary situation of the RMI, including the stabilization of the financial position of SOEs at risk. This will provide a foundation for better service delivery over the long term and, in turn,

[23] Technical Assistance (Appendix 2).
[24] Two JFPR proposals, (i) RMI: Improved Energy Supply for Poor Households and (ii) Regional: Social Protection of the Vulnerable in the Pacific, were endorsed by the Government of Japan in May and June 2010, respectively. ADB Board approval on a no-objection basis will be sought in August 2010.
[25] Grid connection and solar power options were considered, with grid connection assessed to be the least-cost option.
[26] ADB. 2009. *Technical Assistance for Pacific Economic Management.* Manila (TA 7280-REG, subprogram 1).
[27] ADB. 2006. *Technical Assistance for Pacific Private Sector Development Initiative*. Manila (TA 6353-REG); ADB. 2009. *Technical Assistance for Pacific Private Sector Development Initiative, Phase II*. Manila (TA 7430-REG).
[28] Development Coordination (Appendix 2).

encourage private sector development. The private sector will be further assisted by actions to improve the performance of SOEs and replace inefficient taxes. Debt restructuring will reduce the net present value of public debt and lower the RMI's overall debt burden.[29]

B. Governance

37. The program will improve corporate governance in targeted SOEs through the application of good practice principles. Governance standards will be enhanced by an open and transparent approach to the implementation of CAP Advisory Group and TRAM commission recommendations, combined with policy action that enhances stakeholder participation.

38. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and MOF. To support these efforts, relevant provisions of ADB's Anticorruption Policy are included in the draft loan agreement.

C. Poverty and Social

39. Over time, the program will yield broadly distributed social benefits by providing a foundation for improving the fiscal position of the RMI. This will enhance the sustainable delivery of essential services and support for vulnerable members of the community. The Government of Japan has recently approved a new JFPR proposal to establish a social safety net in the RMI. Subject to ADB approval,[30] the project will complement the program by providing additional support.

D. Safeguards

40. The program is classified under safeguard category C for environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

41. The major risk is the sustainability of commitment to reform. However, this risk has been mitigated by carefully sequencing reforms, emphasizing wide community participation in the formulation of the program, and closely coordinating with development partners, including the instigation of a mechanism for development partner coordination. The benefits are expected to outweigh the costs and risks. Major risks and mitigating measures are summarized in Table 3.[31]

Table 3: Summary of Key Risks and Mitigating Measures

Risks	Mitigating Measures
The government's capacity to effectively implement reforms may prove insufficient.	Technical assistance will be provided to the Ministry of Finance, SOEs, and other relevant agencies.
The government's commitment to the current pace of reform may not be sustained if political support is lost.	A public consultation program has been established and is ongoing.[a]

[29] The RMI had external government and government-guaranteed debt of $94.3 million, or 61.7% of GDP, at the end of FY2009. The net present value of the debt is estimated at 35.1% of GDP.

[30] The Government of Japan approved the proposal on 10 June 2010. The proposal will be reviewed by the ADB Board of Directors in August 2010 on a no-objection basis.

[31] Risk Assessment and Risk Management Plan (Appendix 2).

Risks	Mitigating Measures
The MEC will not maintain monthly payments into the RMI sinking fund bank account.	The government will establish a debt-serving sinking fund, which will be linked with the MEC's revenue account for automatic transfers of MEC revenue to the sinking fund.
The government has limited capacity to undertake additional borrowing.	The debt-restructuring portion of the program will reduce the net present value of public debt and lower the RMI’s debt burden.

MEC = Marshalls Energy Company, RMI = Republic of the Marshall Islands, SOE = state-owned enterprise.
[a] Public Consultation Program (Appendix 2).
Source: Asian Development Bank.

V. ASSURANCES AND CONDITIONS

42. The government and MOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement.

43. The loan will become effective only after the government has satisfactorily fulfilled all conditions for the release of the single tranche of subprogram 1. Prior to any disbursement under the program loan for subprogram 1, a subsidiary loan agreement shall have been concluded by and between MOF and the MEC in a form satisfactory to ADB.

VI. RECOMMENDATION

44. I am satisfied that the proposed program cluster and loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the program cluster for the Public Sector Program; and

(ii) the loan of $9,500,000 equivalent to the Republic of the Marshall Islands for subprogram 1 of the Public Sector Program from ADB's Special Funds resources with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; for a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and program agreements presented to the Board.

Haruhiko Kuroda
President

Date

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources	Assumptions and Risks
Impact The public sector provides more efficient and effective services to the population.	One-step grade increase in the country performance assessment rating for criterion 15 - Quality of Public Administration (assessed as 2.0 in 2009) One-step grade increase in the country performance assessment rating for criterion 6 - Business Regulatory Environment (assessed as 2.5 in 2009)	ADB's annual Country Performance Assessment report	**Assumptions** No major political instability occurs during the program. Development partner coordination and effectiveness is enhanced. **Risk** Government capacity to effectively manage a wide-ranging policy program proves insufficient.
Outcome The government achieves fiscal sustainability.	Annual contribution from the General Fund to the compact trust fund by end-FY2012 of at least 3.0% of GDP (loan tranche condition policy matrix 1.1 and 1.2) Compact trust fund assessed by the IMF as on track to achieve FY2023 targets under baseline scenario	MOF annual budget statement IMF Article IV report	**Assumptions** Development partners provide adequate and timely support to fill gaps in financing and human resources. Returns on offshore assets held in the compact trust fund return to normal levels. **Risk** Government succumbs to demands for new and expanded public programs.
Outputs 1. The government's fiscal discipline improves over the medium term.	Ratio of capital expenditure to GDP at least equal to the FY2009 ratio (preliminary estimate of 13.7%) from FY2010 to FY2013 (loan tranche condition policy matrix 1.1 and 1.2)	IMF Article IV Report	**Assumptions** Adverse external shocks to government revenue are absent. Political and community support for fiscal reform endures. **Risks** Recipients of allowances, subsidies, and transfers resist cuts. Government agencies including SOEs lack sufficient technical capacity to raise financial and technical performance. Commitment of government agencies to recurrent expenditure restraint wanes.
2. The cabinet enforces restraint on recurrent expenditure.	Ratio of recurrent expenditure to GDP less than the FY2009 ratio (preliminary estimate of 54.%) in FY2013 Ratio of wages and salaries to GDP less than the FY2009 ratio (preliminary estimate of 22.5%) in FY2013	MOF annual budget statement	
3. MOF increases tax revenue.	Ratio of tax revenue to GDP on track to reach 16.2% in FY2015 (preliminary estimate for FY2009 of 15.2%)	MOF annual budget statement	
4. Selected SOEs improve their	Positive consolidated rate of return on equity of SOEs	Annual external audit reports	

Design Summary	Performance Targets and Indicators with Baselines	Data Sources	Assumptions and Risks
performance.	by 2012 (2008 consolidated return of about –16.4%) MEC's electricity business achieving a net profit in FY2012 (loss in FY2009)	prepared by Deloitte MEC annual financial report	
5. Cabinet ensures effective stakeholder participation in public sector reform initiatives.	Each public consultation program is attended by at least 20 stakeholders. At least 50% of the policy actions in CAP, TRAM, and SOE reform action plans are in line with the comments made by the participants of the public consultation program.	Public consultation program activity report by MOF	

Activities with Milestones	Inputs
Output 1: Government fiscal discipline has improved over the medium term. 1.1 Fiscal analysis for the preparation of budget targets in FY2011–FY2012 (by May 2010) Loan tranche condition 1.2 Preparation of the medium-term fiscal outlooks for FY2011–FY2012 (by August 2010) Loan tranche condition 1.3 Preparation of RMI debt-management guidelines (by August 2010) Loan tranche condition 1.4 Cabinet endorsement of fiscal outlook and debt management guidelines (by August 2010) Loan tranche condition 1.5 Dissemination of medium fiscal outlook through website (by August 2010) **Output 2: The cabinet enforced restraint on recurrent expenditure.** 2.1 Preparation of CAP report and action plans (by January 2010) Loan tranche condition 2.2 Completion of public sector workforce audit (by January 2010) Loan tranche condition 2.3 Cabinet endorsement of the CAP report, action plans, and workforce audit (by June 2010) Loan tranche condition 2.4 Dissemination of CAP report, action plans, and workforce audit (by September 2010) 2.5 Translation of CAP report and action plans to FY2011 budget (by September 2010) Loan tranche condition 2.6 Initial implementation of CAP action plans (by September 2010) Loan tranche condition 2.7 Translation of CAP report and action plans to FY2012 budget (by September 2011) 2.8 Completion of CAP action plans (by April 2013) **Output 3: MOF increased tax revenue.** 3.1 Preparation of TRAM report and action plans (by March 2010) Loan tranche condition 3.2 Completion of IMF–RMI–ADB consultation (by March 2010) 3.3 Cabinet endorsement of the TRAM report and action plans (by May 2010) Loan tranche condition 3.4 Dissemination of TRAM report and action plans (by September 2010) 3.5 Translation of TRAM report and action plans to FY2011 budget (by September 2010) Loan tranche condition 3.6 Initial implementation of TRAM action plans (by September 2010) Loan	**ADB** Loan of $14.5 million equivalent. Subprogram 1: $9.5 million equivalent Subprogram 2: $5.0 million equivalent TA: $600,000 equivalent **Government** Reform actions Financing for capital expenditure Budget management $100,000 in-kind contribution to TA

Activities with Milestones	Inputs
tranche condition 3.7 Translation of TRAM report and action plans to FY2012 budget (by September 2011) 3.8 Completion of TRAM action plans (by April 2013) **Output 4: Selected SOEs improved their performance.** 4.1 Preparation of SOE analysis with donor partners (by March 2010) Loan tranche condition 4.2 Preparation of SOE study document (by March 2010) Loan tranche condition 4.3.ADB Pacific Liaison and Coordination Office feasibility assessment of SOEs in the RMI (by June 2010) 4.4 Cabinet endorsement of the SOE study and SOE good practice principles (by July 2010) Loan tranche condition 4.5 Dissemination of SOEs study document (by September 2010) 4.6 Initial implementation of SOE good practice principles (by September 2010) 4.7 Completion of SOE reform action plans (by April 2013) **Output 5: Cabinet ensured effective stakeholder participation in public sector reform initiatives.** 5.1 Preparation of public consultation program (by January 2010) Loan tranche condition 5.2 Implementation of public consultation program (by February 2010) Loan tranche condition 5.3.Completion of activity report (by April 2010) Loan tranche condition 5.4 Consultation between budget committee and public consultation organizing committee to establish linkage between budget and public consultation outcomes (by November 2010)	

ADB = Asian Development Bank, CAP = Comprehensive Adjustment Program, FY = fiscal year, GDP = gross domestic product, IMF = International Monetary Fund, JFPR = Japan Fund for Poverty Reduction, MEC = Marshalls Energy Company, MOF = Ministry of Finance, RMI = Republic of the Marshall Islands, SOE = state-owned enterprise, TA = technical assistance, TRAM = Tax and Revenue Reform and Modernization.

Source: Asian Development Bank estimates.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=43321-01-3

1. Loan Agreement
2. Program Agreement
3. Sector Assessment (Summary): Multisector
4. Project Classification Summary
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Economic Analysis
8. Country Economic Indicators
9. International Monetary Fund Assessment Letter
10. Summary Poverty Reduction and Social Strategy
11. Risk Assessment and Risk Management Plan
12. List of Ineligible Items
13. Fiscal Analysis and Impact of Reforms
14. Fiscal Reforms and Impacts
15. State-Owned Enterprise Analysis
16. Marshalls Energy Company Analysis
17. Technical Assistance
18. Public Consultation Program
19. ADB Support for Public Sector Reforms in the Pacific, How Do We Do Differently?

Republic of the Marshall Islands
Office of the Minister of Finance

28 June 2010

Mr. Haruhiko Kuroda
The President
Asian Development Bank
Manila
Philippines

Dear Mr. Kuroda,

Subject: Development Policy Letter for Public Service Reform Program

In recent years the Republic of the Marshall Islands (RMI) like many of its neighboring Pacific Island states, has faced increasingly challenging fiscal and economic conditions. Fiscal year (FY) 2008 was a particularly difficult year, with the RMI experiencing major shocks from sharp rises in food, fuel and other commodity prices. These surges translated into double-digit inflation in the RMI during calendar year 2008. The price shocks and other economic challenges prompted the Government to declare a State of Economic Emergency in late FY2008, the first time that we have made such a declaration.

In FY2008, RMI also saw contraction in real gross domestic product (GDP) growth and leveling in formal employment, aggregate wages, and government revenue. Fiscal management has become increasingly challenging, and with very little in terms of financial reserves, we struggle to cope with urgent and unforeseen events.

The impacts of the FY2008 surge in global fuel prices on our main utility company, the Marshalls Energy Company (MEC), were particularly traumatic and occurred at a time when MEC was already suffering from other factors that had pushed it to the brink of insolvency. Between mid- 2008 and mid-2009), the Government found it necessary to transfer nearly $8 million to MEC to meet the cost of diesel fuel imports. Because of the precarious condition of the Government's General Fund, most of this $8 million had to be provided in the form of an advance.

There are several structural deficiencies which are troublesome for the prospect of medium to longer-term growth and development of the RMI. Government operations and overall economic activities and growth are heavily grant dependent. Driven by increasing subsidy to state-owned enterprises (SOEs) and growing civil service payroll Government

expenditures soared to 65% of GDP on average for 2002-2007. This was made possible by the substantial grants provided by the United States (US) under the Compact of Free Association as amended in 2003. Budget support has also been received from Taipei,China since 1999. It is projected that over the longer-term RMI's core revenue will not cover core expenditures due to decrementing Compact grant transfers, poor performance of revenue collection, large grants and subsidies for SOEs and contractions in the US operations on Kwajalein Atoll. The RMI and US Governments are investing in a Compact Trust Fund (CTF) that is intended to generate a revenue stream that can replace US Compact grants in FY2024. The Compact Trust Fund (CTF) earnings may not supplant annual Compact grant transfers beginning in FY2023 signaling the need for running of annual fiscal surpluses to be contributed into the CTF.

Government's Response to the Crisis: Comprehensive Adjustment Program

The Government has developed a comprehensive public sector program. An important component of the Program is the medium-term Comprehensive Adjustment Program (CAP) developed by an Advisory Group which was officially formed in April of 2009 and has since worked closely with the Cabinet and other key stakeholders. The report of the CAP Advisory Group was formally adopted by the Cabinet through a resolution in February 2010.

The overarching objective of the CAP is the stabilization of the fiscal position. More specifically, the Program will aim to achieve three distinct but related goals: (i) to stabilize the Government's fiscal position in the short term, and ensure longer term structural stability and sustainability of Government finances; (ii) to strengthen public sector management capacity, particularly in the core areas of civil service, fiscal and economic management; and (iii) to continue to improve the environment for private sector operations.

In addition, the Program reflects tax and revenue reform measures recommended by the IMF's Pacific Financial Technical Assistance Centre (PFTAC) and the Tax and Revenue Reform and Modernization (TRAM) Commission, and recommendations made in the RMI FY2008 Economic Review and the IMF 2009 Article IV mission report. The Program also includes recommendations derived from analysis of the civil service and SOEs. This included a Public Consultation Program that gathered input from key stakeholder groups on the current fiscal and economic challenges facing the RMI and priorities and options for reform.

The Public Sector Program has come out of a recognition at the highest levels of the Government and among the wider community that the RMI remains highly vulnerable to external shocks and their collateral effects. These challenges point clearly to the need for reform beginning with the re-evaluation and reconsideration of options available for fiscal adjustment and broader public sector reform. The Government endorses the principle that the most appropriate, effective, and sustainable way to respond to the challenges facing the RMI is to develop and execute a practical, comprehensive, and locally-owned policy reform program that pursues achievable, measurable and time-bound medium-term goals and objectives. The Government intends to take action in four specific critical areas of concern highlighted by CAP, TRAM, IMF and ADB. These are outlined below and a time bound action program is laid out in the attached policy matrix.

Medium-Term Fiscal Outlook

The Government has recently endorsed budget targets for FY2011 and FY2012 that will achieve at least 2.3% budget surplus of GDP per annum. The budget surplus will be achieved through restrain of recurrent expenditure and increase of tax revenue. The medium term fiscal target is an increase in the budget surplus to 5.0% of GDP by FY2015, as recommended by the IMF.

Rationalizing Public Expenditures and Improving Service Delivery

I am pleased to inform you that the Government has already completed a preliminary public sector work force audit and reduced public sector workforce by more than 50 from the 2009 level of 2,412. The FY2010 budget contains a 5% reduction of the Government wage bill. During this period the Government will take steps to improve transparency of budget through public debt reporting, trust fund reporting, and mid-term budget status reports. Budget and civil service improvements will continue through FY2011-2012 and beyond. Non-wage expenditures will be reduced, public sector work force audits will be completed, and the Government will start implementing a workforce adjustment plan. In this period major policy actions will be initiated to improve public service delivery and debt management. The Government will prepare and seek Cabinet approval for a public sector debt management strategy to avoid a re-emergence of past difficulties.

Improved Tax Compliance and Enforcement

The Government has carefully reviewed the recommendations of the TRAM and agrees with the IMF and ADB that revenue reform measures need to be initiated under the Public Sector Program to bring the projected fiscal imbalance into manageable proportion. The Government has prepared proposals for unification of tax administration. A proposal will be prepared for audit of tax collection under all headings. A separate proposal will be prepared for harmonizing tax collection processes and information sharing. The final report of the TRAM will be submitted for consideration and approval by the parliament (*Nitijela*).

On the tax front, further measures will be adopted in FY2011 and FY2012. The Government will act to unify tax administration, including legislation for the consideration by the parliament (*Nitijela*). The Government will review and amend as appropriate existing tax laws and/or draft new tax laws for consideration by the parliament and the Cabinet to improve tax administration. The Government will audit tax collection under all headings and harmonize tax collection and information sharing. To get a better handle of tax delinquency and coverage, the Government plans to establish a Tax Intelligence Unit in the Ministry of Finance (MOF). The Government will consult IMF and ADB and identify potential revenue enhancement measures for consideration of the Cabinet. The Government (MOF) will also prepare and start implementing a capacity development plan for tax administration and collection.

Rationalizing State-Owned Enterprises

SOEs in RMI have generally required subsidization from the budget and this has adversely affected the Government's ability to maintain the desired quality and quantity of other essential public services. The Government, therefore, undertook situational audits of all SOEs in FY2009.

The Government has been particularly concerned with the state of MEC. It is a vital utility for the economy and the largest SOE but is on the verge of insolvency due to a combination of external and internal factors. There is a recognition in the Government and among our international development partners that reform of MEC is urgent. The Government has therefore initiated a number of actions addressing problems of MEC. The MEC Board and management have developed a Comprehensive Recovery Plan 2010-2012, the new electricity tariff template has been approved to reflect full cost of production, the Board has been reconstituted with professional members and a new Chief Executive Officer of high standing has been appointed.

The MEC recovery plan aims to stabilize the company's finances and operations (in the short term) and ultimately establish MEC as a reliable and efficient supplier of energy. The MEC recovery plan aims to achieve this through the pursuit of key policy and technical actions so that it can evolve into a fully fledged commercial entity. This will be achieved through capacity development, debt restructuring, improving revenue and cash flow, rationalizing expenditures and reducing losses, eliminating internal cross subsidization and rehabilitating core assets and improving asset management. While the Government is also committed to upholding social and equity considerations, including through an appropriate lifeline tariff that genuinely assists the bottom 20 percent of residential accounts (based on household income levels), the cost of this will not be borne by MEC. Together with MEC, other SOEs will also be taken up for reform and restructuring through 2011 and 2012.

Promoting Public Consultation

The Government will establish a permanent ongoing forum in support of the policy program, with membership from a cross-section of stakeholders to review quarterly the Program and similar other initiatives to ensure that all concerns are duly considered and reflected as appropriate in the implementation strategy and actions initiated.

Mr. President, unfortunately, time is not on our side. With an uncertain domestic and international environment, delays in implementing necessary reforms are likely to be costly. We recognize that reforms are overdue and we are strongly committed to reform. But the Government cannot meet the implicit substantial adjustment costs without assistance from its development partners. The Government will expeditiously implement this Program and carry the momentum of change over the medium and longer-term because we are convinced it will help us attain fiscal balance, improve efficiency of SOEs, improve service delivery, strengthen policy and planning and budgeting, and achieve sustainable inclusive growth enabling us to reduce poverty, and physical and social exclusion and alienation, especially for the people of the outer islands

Yours sincerely,

Jack J. Ading
Minister of Finance

POLICY MATRIX

Medium Term Direction	Policy Actions under Subprogram 1 Single Tranche Release (August 2010)	Triggers for Subprogram 2 Single Tranche Release (indicative date of Feb 2012)
Output 1. Improved medium term fiscal outlook		
Achievement of fiscal discipline	**1.1 Cabinet endorsement of budget targets for FY2011 and FY2012** (i) an average, annual budget surplus over FY2011 and FY2012 of approximately 3.0% of GDP; (ii) an average, annual contribution from the General Fund to the compact trust fund over FY2011 and FY2012 of at least 1.5% of GDP (approx $2.5 million); to be achieved through the policy actions of Outputs 2 and 3 and adherence to (iii) a reduction in the ratio of 'wages and salaries' to GDP to 21.0% by FY2012 (preliminary estimate of 22.3% for FY2010); (iv) a reduction in the ratio of 'subsidies and transfers' to GDP to 9.0% by FY2012 (preliminary estimate of 10.1% for FY2010); (v) a ratio of 'capital expenditure' to GDP of at least 13.0% in FY2011 and FY2012 (preliminary estimate of 13.7% for FY2010); and (vi) an increase in the ratio of 'tax revenue' to GDP to 16.5% by FY2012 (preliminary estimate of 16.2% for FY2010). *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes approving each of the foregoing)*	1.1 Achievement of budget targets for FY2011 and FY2012 1.2 Cabinet endorsement of updated budget targets for FY2013 of a contribution from the General Fund to the compact trust fund of at least 3.0% of GDP (approx. $5.2 million) and targets for 'wages and salaries', 'subsidies and transfers', 'capital expenditure' and 'tax revenue'
	1.2 Cabinet endorsement of public sector debt management guidelines for FY2011 and FY2012 (i) a freeze on new borrowing to fund expenditure of the general government sector of government ministries; (ii) a freeze on the level of non-concessional borrowing by 11 SOEs; (iii) no government lending or loan guarantees to parties outside the public sector; and (iv) concessional borrowing by SOEs to require prior-approval of Cabinet. *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes and a copy of the public sector debt management guidelines)*	1.3 Adherence to the public sector debt management guidelines for FY2011 and FY2012 1.4 Cabinet endorsement of a public sector debt management strategy to become effective in FY2013 1.5 Parliament endorsement of fiscal responsibility legislation
Output 2. Restraint of recurrent expenditure		
Government expenditure at	**2.1 Conduct of an independent review of public expenditure by the CAP Advisory Group and Cabinet endorsement of the Group's report** *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet*	

Medium Term Direction	Policy Actions under Subprogram 1 Single Tranche Release (August 2010)	Triggers for Subprogram 2 Single Tranche Release (indicative date of Feb 2012)
sustainable levels	*minutes and a copy of the report)*	
	2.2 Cabinet endorsement of key CAP recommendations for implementation in the FY2011 and FY2012 budgets (i) reduction in over-budgeting of the wage and salary bill by eliminating 50 vacant positions (equivalent in value to 5% of the FY2010 budget allocation for wages and salaries); (ii) one off cut and then a freeze in grants and subsidies to 11 SOEs; electricity concessions provided to land owners affected by MEC operations; travel and per diem expenses; and government operating expenditure on housing leases and rental, electricity, water, communications, vehicles, fuel and professional services; and (iii) a freeze on the wage and salary bill of the civil service, Nitijela members compensation and housing allowances for public officials. *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes)*	2.2 Implementation through the FY2011 and FY2012 budgets of actions to control recurrent expenditure and no reversal in the FY2013 budget
	2.3 Cabinet endorsement of key recommendations from work force audits (i) conduct of work force audits performed by independent consultants for 3 major Ministries (Education, Health and Public Works); and (ii) review and endorsement by Cabinet of key recommendations in the work force audits, relating to reducing budget allocations to civil servant salaries and wages. *(Tranche Condition: MOF to provide ADB a copy of the audits and Cabinet minutes endorsing the recommendations contained therein)*	2.3 Public sector work force audits completed for 6 other Ministries 2.4 Action commenced in at least 3 Ministries to improve productivity, drawing on the findings of the work force audits
Output 3. Increased tax revenue		
Tax revenue raised to 20% of GDP and collected in a more efficient and equitable manner	**3.1 Completion of an independent assessment of the tax system by the TRAM commission and Cabinet endorsement of the commission's report** *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes and a copy of the report)*	
	3.2 Cabinet endorsement of time-bound actions (to be performed by FY2015) to improve the efficiency and equity of the tax system, with implementation to commence in FY2011 (i) adoption of a broad-based consumption tax as a replacement of existing distortionary taxes; (ii) adoption of excises on alcohol, tobacco, motor vehicles and fuels as a replacement	3.1 Implementation of time-bound actions on-track

Medium Term Direction	Policy Actions under Subprogram 1 Single Tranche Release (August 2010)	Triggers for Subprogram 2 Single Tranche Release (indicative date of Feb 2012)
	of existing distortionary taxes; (iii) adoption of new income tax rates and a reduction in exemptions to reduce the overall regressivity of the tax system; and (iv) improvement in compliance by streamlining and consolidating the multiple tax monitoring and collection systems. *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes)*	
Output 4. Improved performance of SOEs		
Financial performance and corporate governance standards match regional benchmarks	**4.1 Endorsement by Cabinet of recommendations for improving SOE performance** (i) conduct by independent consultants of an assessment of the commercial performance of 11 major SOEs and identification of options to improve performance; and (ii) review and endorsement by Cabinet of the key recommendations of such assessment relating to improving SOE performance. *(Tranche Condition: MOF to provide ADB a copy of the assessment and Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes)*	4.1 Continued annual public reporting on SOE performance and progress of the Program
	4.2 Cabinet endorsement of good practice principles for 11 SOEs (i) establishment and public release of plans approved by Cabinet and SOE Boards that set out the strategic direction of SOEs and performance targets; (ii) identification of essential activities and the sale or winding down of non-essential activities; (iii) ensuring SOE boards have independence in operation and are staffed by suitably qualified and experienced members; (iv) ensuring senior management of SOEs have suitable qualifications and experience; (v) alignment of prices and charges with the total cost of service delivery, except where funded by community service obligations; (vi) sound financial management of SOEs including the timely production of audited accounts; (vii) authorization of the MOF to introduce establishment of an SOE policy and SOE act to provide mechanisms for the sound application of good practice principles; and (viii) confirmation by the MOF of commencement of preparation of an SOE act to provide mechanisms for the sound application of good practice principles, to be	4.2 Adoption of an SOE policy by the Parliament and implementation of an SOE act to give effect to the good practice principles for SOEs

Medium Term Direction	Policy Actions under Subprogram 1 Single Tranche Release (August 2010)	Triggers for Subprogram 2 Single Tranche Release (indicative date of Feb 2012)
	submitted to the Parliament within calendar year 2010. *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes)*	
	4.3 MEC comprehensive recovery plan prepared and endorsed by the MEC board *(Tranche Condition: MOF to confirm board endorsement and provide ADB a copy of the plan and of the minutes of the MEC board minutes and publication on applicable government website of the plans)*	4.3 Implementation initiated of time-bound recovery plans for at least 3 SOEs that apply the good practice principles
	4.4 Implementation of MEC comprehensive recovery plan commenced (i) reduction of MEC board membership from 10 to 7 members and inclusion of members with private sector/commercial experience and that represent customer interests (action 1.1.1 of the Plan); (ii) adoption of a new procurement policy (action 24.1.1 of the plan), new financial management and reporting policies (action 24.1.3 of the Plan) and a new vehicle policy (action 24.1.4 of the plan); (iii) adoption of a revised tariff template to reflect increased costs since its inception in 2007 that will be applied quarterly to ensure electricity tariffs cover at least 75% of the operating cost plus interest cost of the electricity business (action 3.1.1 of the Plan), and (iv) strengthening of procurement procedures, including requiring that all tenders must be competitively bid with a minimum of three eligible bidders (action 3.24.6 of the Plan). *(Tranche Condition: MOF to confirm (i), (ii), and (iv) by MOF letter to ADB. For (iii), MOF to supply a copy of documents reflecting the application of the new tariffs over the preceding four quarters)*	4.4 MEC comprehensive recovery plan on-track to achieving full board independence, creation of a statement of plan that sets out MEC's strategic direction and performance targets, full cost recovery (of operating costs and interest) on the electricity business no later than FY2013 through tariff adjustments, cash collection efficiency, improvements in operating efficiency and a reduction in account receivables below 61 days
	4.5 Cabinet and MEC board endorsement of actions to restructure MEC debt (i) establishment of a financing agreement between the MOF and MEC that will be used to reform and stabilize the MEC; (ii) deferral of principal repayments for 3 to 5 years of the existing loan with the Rural Utility Services of the US Department of Agriculture; and (iii) establishment by the MOF and MEC of a debt servicing sinking fund for the financing agreement between the MOF and MEC. *(Tranche Condition: Secretary to Cabinet to provide ADB a certified extract of Cabinet minutes and of relevant minutes of the MEC board)*	4.5 Actions to restructure MEC debt implemented and no reversal

Medium Term Direction	Policy Actions under Subprogram 1 Single Tranche Release (August 2010)	Triggers for Subprogram 2 Single Tranche Release (indicative date of Feb 2012)
	4.6 MEC Board endorsement of a maintenance & repair account to hold sufficient funds set-aside to meet all MEC maintenance & repair needs *(Tranche Condition: Copy of the minutes of the board endorsing the plan and a copy of the plan)*	4.6 MEC maintenance account effective
Output 5. Effective stakeholder participation		
Enhanced bottom up planning and community participation	**5.1 Implementation of a public consultation program through stakeholder forum** *(Tranche Condition: MOF to provide ADB a copy of the findings of the program and to confirm the implementation and announcement on government website http://www.rmigovernment.org)*	5.1 Continued implementation of a public consultation program
	5.2 SOE,TRAM Commission, and CAP Advisory Group reports publicly available *(Tranche Condition: MOF to confirm the publication of such reports and the manner of publication, including on the relevant government website http://www.rmigovernment.org)*	

Note: Short term policy actions yet to be completed are shown in bold
ADB = Asian Development Bank, CAP = Comprehensive Adjustment Program, FY = fiscal year, MEC = Marshalls Energy Company, MOF = Ministry of Finance, SOE = state-owned enterprise, TRAM = Tax and Revenue Reform and Modernization.
Source: Ministry of Finance and Marshalls Energy Company.