



Report and Recommendation of the President to the Board of Directors

Project Number: 50295-001
September 2017

Proposed Grant Republic of the Marshall Islands: Public Financial Management Project

Distribution of this document is restricted until it has been approved by the Board of Directors. Following such approval, ADB will disclose the document to the public in accordance with ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENTS

The currency of the Marshall Islands is the United States dollar.

ABBREVIATIONS

ADB	–	Asian Development Bank
AVI	–	Australian Volunteers International
CSO	–	community service obligation
FMIS	–	financial management information system
GDP	–	gross domestic product
MOF	–	Ministry of Finance
PAM	–	project administration manual
PEFA	–	public expenditure and financial accountability
PFM	–	public financial management
PFTAC	–	Pacific Financial Technical Assistance Centre
PSDI	–	Private Sector Development Initiative
RCU	–	reform coordination unit
SOE	–	state-owned enterprise
TA	–	technical assistance

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., FY2017 ends on 30 September 2017.
- (ii) In this report, "\$" refers to US dollars.

Vice-President	S. Groff, Operations 2
Director General	M. C. Locsin, Pacific Department (PARD)
Director	E. Veve, Pacific Urban, Social Development and Public Sector Management Division, PARD
Team leader	A. Basu, Principal Economist, PARD
Team members	J. Dela Cruz, Operations Assistant, PARD Y. Li, Counsel (Sovereign Operations), Office of the General Counsel E. Milne, Development Coordination Officer, PARD R. Rabanal, Senior Economics Officer, PARD
Peer reviewer	H. Mukhopadhyay, Principal Public Management Specialist, Central and West Asia Department

In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.

CONTENTS

	Page
PROJECT AT A GLANCE	
I. THE PROJECT	1
A. Rationale	1
B. Impact and Outcome	4
C. Outputs	4
D. Summary Cost Estimates and Financing Plan	6
E. Implementation Arrangements	6
II. DUE DILIGENCE	8
A. Economic and Financial	8
B. Governance	8
C. Poverty, Social, and Gender	9
D. Safeguards	9
E. Summary of Risk Assessment and Risk Management Plan	10
III. ASSURANCES	10
IV. RECOMMENDATION	10
APPENDIXES	
1. Design and Monitoring Framework	11
2. List of Linked Documents	14

PROJECT AT A GLANCE

1. Basic Data		Project Number: 50295-001	
Project Name	Public Financial Management Project	Department /Division	PARD/PAUS
Country Borrower	Marshall Islands, Republic of Republic of the Marshall Islands	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Public sector management	Public expenditure and fiscal management		1.60
	Reforms of state owned enterprises		0.40
		Total	2.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Institutional development	Some gender elements (SGE)	✓
Knowledge solutions (KNS)	Public financial governance		
Partnerships (PAR)	Knowledge sharing activities		
	Implementation		
	International finance institutions (IFI)		
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		2.00	
Sovereign Project grant: Asian Development Fund		2.00	
Cofinancing		0.00	
None		0.00	
Counterpart		0.30	
Government		0.30	
Total		2.30	

I. THE PROJECT

1. I submit for your approval the following report and recommendation on a proposed grant to the Republic of the Marshall Islands (RMI) for the Public Financial Management Project.¹

2. The Asian Development Bank (ADB) proposes to support the Government of the Marshall Islands through a project grant to strengthen overall public financial management (PFM). The project will enhance the institutional capacity of the Ministry of Finance (MOF) to effectively implement PFM and state-owned enterprise (SOE) reforms.

A. Rationale

3. **Key challenges.** The RMI faces natural disadvantages, exposure to shocks, and internal bottlenecks that limit growth prospects. It is classified as a fragile and conflict-affected situation by ADB.² The RMI depends heavily on external development assistance. A major challenge is achieving fiscal sustainability when grants under the Compact of Free Association with the United States expire in 2023.³ Weak management of public finances and SOEs are critical factors constraining the government's ability to strengthen its fiscal position, and improve financial planning and resource allocation for sectoral priorities.⁴ However, the RMI lacks the institutional capacity to effectively implement PFM and SOE reforms.

4. **Weak public financial management framework.** A 2012 public expenditure and financial accountability (PEFA) assessment of the RMI's PFM framework highlighted significant weaknesses,⁵ including (i) budgets that are not executed as planned across line ministries, undermining strategic resource allocation; (ii) significant government spending that is not reflected in budget documents; (iii) weak links between planning and budgeting processes; (iv) frequent budget reallocations that further delink policy priorities from sectoral allocations; (v) accounting and reporting limitations that hamper budget execution monitoring; (vi) weaknesses in tax administration and management; and (vii) the absence of effective external scrutiny and audit, and limited follow-up of audit findings. The absence of a dedicated MOF website makes it difficult to effectively communicate PFM reforms to stakeholders (including the public).

5. A 2016 assessment further found that, over the last several years, the MOF has experienced high turnover and loss of senior staff, and has received diminished support for *4Gov*, the Marshall Islands' financial management information system (FMIS).⁶ The report recommended that technical assistance (TA) be mobilized to (i) strengthen professional accounting capacity;⁷ (ii) improve human resource development, training, and processes to address staff turnover and vacancies, and low staff morale; and (iii) ensure an FMIS acquisition process to replace *4Gov* that with an appropriate system software solution.

¹ The project was prepared under Asian Development Bank. 2013. *Technical Assistance for Strengthening Public Sector Management in the North Pacific*. Manila (TA 8581-REG).

² ADB Fragile Situations Resource Center (<http://fragilesituations.adb.org>).

³ Fiscal balances (including grants) show only a small deficit, averaging 1.4% of gross domestic product (GDP) during FY2012–FY2016. However, budgetary grants total about a third of GDP; when grants are excluded the fiscal deficit over FY2012–FY2016 was almost 31% of GDP.

⁴ Sector Assessment (Summary): Public Sector Management (accessible from the list of linked documents in Appendix 2).

⁵ Government of the Marshall Islands. 2012. *PEFA Public Financial Management Performance Report*. Majuro.

⁶ Graduate School USA. 2016. *Republic of the Marshall Islands. Ministry of Finance Risk Assessment*. Majuro.

⁷ The MOF relies on their external auditor to prepare annual financial statements. Although the financial statements have received a clean opinion, they have not met audit completion deadlines since 2011. Questionable costs identified by the auditors remain a concern. The most common observations are the lack of documentation and outstanding reconciliation among various records. ADB has supported the government to improve documentation.

6. **Public Financial Management Reform Roadmap.** Based on the PEFA, the government developed the PFM Reform Roadmap 2014–2016 consisting of 30 reform components.⁸ The Roadmap calls for a governance structure to guide reform implementation, and nonsystem measures for strengthening coordination and oversight, and capacity building. Key reform components include enhancing aid coordination for PFM reforms, improving the budgeting framework, strengthening accounting systems and cash management, augmenting internal and external audit capacity, upgrading human resources (including payroll systems), promoting better fiscal management, and monitoring SOEs. The Roadmap recognizes the importance of communication and training in PFM reform for greater transparency and sustainability.

7. **Public financial management reform implementation.** In December 2015, following general elections, the Roadmap was endorsed by the Cabinet. A PFM Reform Steering Committee chaired by the chief secretary was established in March 2016 to provide high-level management. The MOF leads efforts to implement the Roadmap. While the authorities are committed to reforms, the Roadmap lacks systematic prioritization. Together with high turnover of staff and insufficient capacity in the MOF, this has meant that the Roadmap remains a wish list, with limited progress in implementation. Senior MOF staff are overloaded with multiple responsibilities. Lower-level MOF staff are largely either high school graduates or college graduates with liberal arts backgrounds, with inadequate knowledge of economics or accounting.⁹ Understanding of the FMIS is weak, except among staff trained in information technology—although able to operate *4Gov*, they often lack the nonsystems financial knowledge required to generate appropriate reports.

8. Insufficient capacity constrains the ability of the MOF to effectively coordinate Roadmap implementation. Internal coordination on PFM issues among agencies such as the MOF, the Economic Policy Planning and Statistics Office, the Ministry of Foreign Affairs, and line ministries is weak—agencies outside the MOF have insufficient understanding of their financial reporting responsibilities, and are often unable to comply with core financial regulations. There is also a need for better development partner coordination. Key partners supporting PFM reforms include ADB, the World Bank, the Pacific Financial Technical Assistance Centre (PFTAC), the European Union, and the governments of Australia and the United States.¹⁰ The MOF must establish an effective coordination mechanism among them to ensure that PFM reform efforts achieve timely results, while avoiding duplication or contradictory advice.

9. **Fiscal burden of state-owned enterprises.** The RMI's SOE sector is one of the weakest performers in the Pacific.¹¹ There are 11 active SOEs involved in utilities, transport, banking, telecommunication, and hotels. In FY2014, these SOEs represented 17%–20% of the total capital stock of the country, but contributed only 5.3% to gross domestic product (GDP).¹² SOEs provide a range of public services with non-commercial objectives, and receive significant government transfers and access to discounted debt subsidized to fund their community service obligations (CSOs). Annual government transfers to SOEs during FY2004–FY2015 averaged 4.1% of GDP, and the gap between commercial loan rates and the concessional rates SOEs paid on their debt averaged more than 7.7%. The negative rates of return and high ongoing government contributions pose a fiscal burden that diverts money from much-needed social services.

⁸ Government of the Marshall Islands. 2014. *Public Financial Management Reform Roadmap 2014–2016*. Majuro.

⁹ Summary Human Resource Assessment for the Ministry of Finance (accessible from the list of linked documents in Appendix 2).

¹⁰ Development Coordination (accessible from the list of linked documents in Appendix 2).

¹¹ ADB. 2016. *Finding Balance: Benchmarking the Performance of State-Owned Enterprises in Island Countries*. Manila.

¹² The RMI's overall SOE portfolio generated losses each year from 2002 to 2014, with an average return on assets of –5.0% and return on equity of –11.1%.

Stemming the requirement for substantial fiscal transfers to SOEs is a critical part of overall PFM reforms. However, because the costs of delivering legitimate CSOs has not been estimated, the government is unable to determine whether the subsidies to SOEs are funding CSOs or covering inefficiencies. The absence of a centralized monitoring unit for SOEs within the MOF diffuses responsibility and makes it difficult to enforce fiscal discipline.

10. **State-Owned Enterprises Act implementation.** The RMI adopted the State-Owned Enterprises Act¹³ in October 2015 to strengthen corporate governance and monitoring of SOEs, with support from ADB through its Private Sector Development Initiative (PSDI).¹⁴ The SOE Act enables the commercialization of the SOEs and contains a sound corporate governance framework, but has been weakened somewhat by a 2016 amendment that allows elected officials to remain on SOE boards. The PSDI TA is assisting in implementation of the SOE Act, including through measures for greater transparency, accountability, and disclosure among SOEs.¹⁵ Although the MOF is responsible for implementing the SOE Act, capacity limitations and insufficient understanding within the MOF of their SOE monitoring role have constrained effective implementation. Line ministries and senior managers from SOEs are also often unable to meet the reporting and accountability requirements under the SOE Act.

11. **Proposed solutions.** ADB proposes to support the government through an Asian Development Fund project grant to address the low institutional capacity of the MOF to effectively implement PFM and SOE reforms, as requested by the government in 2016. The project is aligned with a crosscutting theme of the RMI National Strategic Plan 2015–2017, of ensuring and applying good governance principles to achieve effective governance.¹⁶ PFM and SOE reforms are two strategic areas under the Plan. The project is consistent with the ADB Pacific Approach 2016–2020, which serves as the overall ADB country partnership strategy for the Marshall Islands, and supports the following outcomes: (i) PFM improvements to achieve greater resilience to external economic and financial shocks, and (ii) increased financial efficiency of SOEs to create a more conducive environment for business.¹⁷ ADB’s approach towards engaging in fragile and conflict-affected situations, such as the RMI, recognizes the importance of institutional strengthening and capacity building.¹⁸ The project grant is included in ADB’s lending pipeline for 2017.¹⁹ The project has been developed in coordination with other development partners (footnote 10).

12. **ADB contributions and lessons.** This project builds on prior ADB support to the RMI for PFM and SOE reforms. Through two subprograms under the Public Sector Program,²⁰ ADB assisted the RMI to adopt and implement reform plans to improve the performance of selected SOEs, complete a workforce audit exercise for selected government agencies, and achieve various expenditure targets. ADB regional TA has helped the RMI improve governance within SOEs and develop SOE policy and legislation (para. 10). ADB has helped the government develop a financial management model, periodically clear its audit backlogs, and—through the

¹³ Government of the Marshall Islands. 2015. *State-Owned Enterprises Act, 2015*. Title 52 – Associations Law. Majuro.

¹⁴ ADB. 2010. *Pacific Economic Management–Enhanced Economic Management (Subproject 2)*. Manila; and ADB. 2010. *Pacific Private Sector Development Initiative Phase II*. Manila; and ADB. 2013. *Pacific Private Sector Development Initiative Phase III*. Manila.

¹⁵ The PSDI is developing a website for SOEs in the Marshall Islands to enhance transparency and accountability, as well as provide a useful platform to post new information.

¹⁶ Government of the Marshall Islands. 2014. *National Strategic Plan 2015–2017*. Majuro.

¹⁷ ADB. 2016. *Pacific Approach 2016–2020*. Manila.

¹⁸ ADB. 2013. *Operational Plan for Enhancing ADB’s Effectiveness in Fragile and Conflict-Affected Situations*. Manila.

¹⁹ ADB. 2016. *Country Operations Business Plan, Marshall Islands, 2017–2019*. Manila.

²⁰ 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.

national development coordination officer—is providing ongoing technical accounting support to the MOF. TA has also been provided to assess ways to improve aid coordination. ADB engagement has demonstrated the importance of taking into account the slow pace of reforms in the RMI, having realistic targets in the design and monitoring framework, and providing on-the-ground support for development partner coordination (footnote 10). Accordingly, the project has been designed to provide locally based support and allow flexibility in reform implementation.

B. Impact and Outcome

13. The Asian Development Fund project grant will (i) help the MOF to prioritize and implement the RMI's PFM Reform Roadmap, and (ii) provide operational support to SOE reforms, complementing the policy and legislative support being provided by the PSDI. The project is aligned with the following impact: more effective governance achieved in the Marshall Islands, in line with the National Strategic Plan (para. 11). The project outcome will be improved PFM.²¹

C. Outputs

14. The outputs will be (i) the MOF's institutional capacity to implement the PFM Reform Roadmap strengthened, and (ii) the MOF's institutional capacity to implement SOE reforms strengthened.

15. **Road map implementation.** To achieve the first output, a reform coordination unit (RCU) will be established, consisting of five long-term individual consultants reporting to the secretary for finance. The RCU will be largely based in Majuro, to enable provision of on-the-ground support. The RCU will strengthen MOF capacity to implement the PFM Reform Roadmap through advice, inputs, and training in close coordination with development partners.²²

16. The PFM Reform Roadmap consists of 30 reform components. A key reform is improving coordination of development partner assistance (para. 6). Under the oversight of the secretary, the RCU will prepare a sequenced action plan based on the Roadmap. The action plan will form the basis for identifying the specific reform actions to be prioritized and implemented, around which development partner technical and financial assistance can be mobilized. The RCU will support the secretary to coordinate internally across government agencies, and externally among partners. Although the RCU will not directly support all 30 Roadmap reform components, it will advise the MOF to channel development partner support appropriately.²³

17. The RCU consultants will directly build MOF capacity to implement reforms under other key Roadmap components described below, identified in consultation with development partners. They will also help improve PFM data quality through process improvements. Because the reform sequence will depend on the action plan to be prepared and the timely availability of development partner assistance, in order to allow flexibility, details on the specific reform actions to be undertaken within various components will be worked out under the project.

²¹ The design and monitoring framework is in Appendix 1.

²² The World Bank expects to provide a \$5 million grant in 2018 that seeks to replace *4Gov*, update related processes, and improve procurement systems. Australian Volunteers International will field a short-term consultant in 2017 to help develop a human resource upgradation plan for the MOF, and the World Bank expects to fund capacity building courses and programs for MOF staff. PFTAC provides TA in selected areas (e.g., revenue forecasting, national income calculations, and medium-term budgeting), although they have no long-term consultants based in Majuro.

²³ The RCU consultants will take the lead in coordinating reforms in their respective areas of expertise. It is not expected that they will personally undertake all relevant Roadmap reforms, but will seek to achieve results through a mix of their own expertise, MOF expertise, and, where available, supplementary external expertise using development partner resources.

- (i) **Budget framework.** The RCU will support the MOF to introduce a medium-term budgeting framework, and improve the link between budget documents and corporate and sector planning processes. The RCU will guide the MOF in preparing better budget analyses and documentation, reviewing existing operational budgetary processes, identifying gaps, and recommending and implementing improvements, thus improving quality of budgetary data.
- (ii) **Accounting and auditing.** The RCU will help improve the application of accounting principles in routine government processes, work with the MOF and line ministries to improve cash and asset management, and build a system to perform a daily consolidation and reporting of the government's cash position, all of which will improve quality of financial management data. They will recommend core PFM functionalities to serve as minimum requirements in a potential new FMIS, and advise on FMIS guidelines and manuals. They will help the government's newly appointed internal auditor to implement audit recommendations, review financial reports, and make recommendations as necessary.²⁴ They will also support external audit.
- (iii) **Human resources.** The RCU will work with development partners to advise on a plan to upgrade the MOF's human resources, which is slated to be prepared by a Australian Volunteers International (AVI) consultant. The RCU will ensure that the plan contains appropriate provisions for training, recruitment, and promotion of qualified women. The RCU will work to implement the plan, coordinate development partner support to prepare job descriptions, fund suitable training programs and courses, and strengthen performance management. The RCU will advise on payroll management, and the development and implementation of a new human resource management information system.

18. The RCU will organize at least three structured training sessions per year for MOF employees to strengthen skills required to perform day-to-day PFM functions; the sessions will be identified in the RCU's annual work plans (para. 25). The RCU will also work closely with the MOF and line ministries (through functional hands-on training) to build their capacity to undertake core PFM tasks under their areas of expertise. The RCU will support implementation of the human resources upgradation plan, and mobilize partner funding for formal training courses (footnote 9).

19. **State-owned enterprise reform implementation.** Under the second output, the MOF's capacity to identify, assess the cost of, and monitor legitimate CSOs will be enhanced. The project grant will support the appointment of two SOE reform experts, who will work closely with the PSDI and be part of the RCU for the duration of their recruitment. One expert will help identify legitimate CSOs and assess their costs, with a focus on those SOEs that receive the largest government subsidies.²⁵ This will allow the government to evaluate whether subsidies are funding legitimate CSOs or SOE inefficiencies, which will be the first step towards reforming inefficient SOEs by streamlining subsidies to match public service delivery costs. A second expert will help establish an SOE monitoring unit within the MOF, drawing on existing MOF staff. The expert will help build capacity within the unit to monitor SOE performance and ensure the government gets value-for-money from its fiscal support to SOEs. Limiting SOE subsidies to CSOs will strengthen the discipline on SOEs, help equalize competition with commercially viable businesses, and improve the environment for private sector growth.²⁶

²⁴ The MOF has recruited an internal auditor in 2017.

²⁵ Five SOEs accounted for 83% of all government subsidies to SOEs during FY2004–FY2015: the Kwajalein Atoll Joint Utility Resources, the Tobolar Copra Processing Authority, the Marshall Islands Shipping Corporation, Air Marshall Islands, and the Marshalls Energy Company.

²⁶ The International Monetary Fund has also highlighted that clarifying SOE CSOs and establishing a centralized

D. Summary Cost Estimates and Financing Plan

20. The total cost of the project is estimated to be \$2.3 million (Table 1). The major expenditure item is consulting services. Detailed cost estimates by expenditure category and by financier are included in the project administration manual (PAM).²⁷

Table 1: Summary Cost Estimates

Item	Amount ^a (\$)
A. Base Cost^b	
1. Road map implementation	1,784,356
2. State-owned enterprise reforms	405,200
Subtotal (A)	2,189,556
B. Contingencies^c	110,444
Total (A+B+C)	2,300,000

^a Costs includes taxes and duties of \$108,000 to be financed from government resources as part of their contribution.

^b In mid-2017 prices. The currency of the Marshall Islands is the US dollar.

^c Physical contingencies are estimated at 3.0% for consulting services. Price contingencies are computed at 1.5%–1.6% on foreign exchange costs and 1.5%–1.8% on local currency costs, and includes provision for potential exchange rate fluctuation under the assumption of purchasing power parity exchange rate.

Source: Asian Development Bank estimates.

21. The government has requested a grant not exceeding \$2.0 million from ADB's Special Funds resources to help finance the project. The government will provide counterpart support in the form of staff time, office space and supplies, taxes and duties, secretarial assistance, and other in-kind contributions estimated at \$0.3 million (Table 2). The project will act to improve development partner coordination, as the RCU (once established) can help to channel development funds towards appropriate PFM activities and coordinate with parallel financed initiatives. Therefore, although there is no immediate partner cofinancing, parallel financing is expected to be mobilized during project implementation (footnote 22).

Table 2: Financing Plan

Source	Amount (\$)	Share of Total (%)
Asian Development Bank		
Special Funds (Asian Development Fund) resources (grant)	2,000,000	87.0
Government of the Marshall Islands (in-kind contributions)	300,000	13.0
Total	2,300,000	100.0

Source: Asian Development Bank estimates.

E. Implementation Arrangements

22. The MOF will be the executing agency, and the RCU (once established) the implementing agency. The PFM Reform Steering Committee will provide strategic oversight and guidance. Consultant recruitment will be delegated to ADB, but consultants will be engaged by and report to the MOF.

23. The project is expected to mobilize a senior individual international consultant for 22 person-months to head the RCU, and act as advisor to the MOF on PFM reforms. The advisor will be supported by four long-term consultants, who will be RCU team members.²⁸ Two individual international consultants specializing in financial management will be recruited for 22 person-

monitoring unit that builds on the SOE Act, will be particularly important. International Monetary Fund. 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.

²⁷ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

²⁸ The outline terms of reference for the consultants are in Project Administration Manual (accessible from the list of linked documents in Appendix 2).

months each as RCU team members to support capacity building and reforms in accounting and auditing.²⁹ Two individual national consultants, preferably with government experience, will be recruited for 33 person-months each as RCU members: one PFM specialist to work on budget framework reforms and capacity building, and one human resource specialist to work on upgrading the MOF's human resources and capacity.³⁰ For SOE reforms, the project is additionally expected to mobilize 6 person-months each of two individual international consultants (para. 19). In the selection of consultants, preference will be given to qualified women.

24. The implementation arrangements are summarized in Table 3 and described in detail in the PAM (footnote 27).

Table 3: Implementation Arrangements

Aspects	Arrangements
Implementation period	November 2017–December 2020
Estimated completion date	31 December 2020
Estimated grant closing date	30 June 2021
Management	
(i) Oversight body	Public Financial Management Reform Steering Committee Chief Secretary (chair) Secretary for Finance (member) Auditor General (member) Attorney General (member) Chair of the Public Service Commission (member)
(ii) Executing agency	Ministry of Finance
(iii) Implementing agency	Reform coordination unit
(iv) Implementation unit	Reform coordination unit, five staff (i) advisor, (ii) public finance specialist, (iii) two financial management specialists, and (iv) human resource specialist
Consulting services	Individual consultant selection 144 person-months \$1.756 million
Advance contracting	Advance contracting for consultants
Disbursement	The grant proceeds will be disbursed following the Asian Development Bank (ADB) <i>Loan Disbursement Handbook</i> (2017, as amended from time to time) and detailed arrangements agreed upon between the government and ADB

Source: Asian Development Bank.

25. Based on the Roadmap action plan (para. 16), the RCU will prepare annual work plans outlining capacity-building measures, training sessions to be organized, and specific reform actions to be implemented. The RCU will be required to submit biannual progress reports (including on gender actions) against their work plans to the MOF for their performance review. Evaluation of their performance will also consider the findings of assessments by ADB and development partners.³¹ The RCU will provide biannual updates to the PFM Reform Steering Committee on reform progress and outstanding issues requiring high-level intervention.

26. Capacity will be built within the government to implement Roadmap and SOE reforms, which will help to sustain reforms (para. 18). The two national RCU consultants can potentially be absorbed within the MOF at the end of the project. However, given the shortage of qualified staff in the RMI, it is possible that further support in the form of an RCU will be needed. If the project is judged to be performing well, ADB will make efforts to involve development partners in funding the RCU. Additional financing by ADB may also be considered.

²⁹ The MOF requested two financial management specialists with expertise in accounting, as capacity in this field is particularly weak. This is in line with external analysis (para. 5). The human resource assessment undertaken under project preparatory TA confirmed that, of 78 MOF staff in position in June 2017, only 4 had university degrees in accounting. The MOF, unusually, often relies on external auditors to prepare annual financial statements.

³⁰ The remuneration of the national consultants will be benchmarked to the MOF salary scales, taking into account their experience and qualifications.

³¹ This includes ADB's country performance assessments for the Marshall Islands and the next PEFA study.

27. ADB will continue close coordination with development partners to ensure that respective reform efforts are complementary. The World Bank is also expected to provide support for RMI PFM activities, with an initial focus on the FMIS and reporting processes (footnote 22). Once established and functional, the RCU can provide advice and inputs on adoption of the most appropriate FMIS solution, and help to identify and implement the core nonsystems improvements needed to ensure a timely, user-friendly replacement for *4Gov*. PFTAC is also assisting the government to develop a medium-term fiscal framework. The RCU can work with PFTAC to build the MOF's capacity to undertake fiscal work, providing continuity to the intermittent PFTAC support from experts who visit Majuro periodically. The RCU human resource specialist will coordinate with the AVI consultant to support the development and implementation of a plan to upgrade the MOF's human resources, and help mobilize partner support to fund formal training programs to strengthen MOF capacity.

II. DUE DILIGENCE

A. Economic and Financial

28. The project is expected to generate substantial economic benefits.³² Direct benefits will come from a reduction in SOE subsidies—CSOs will be identified and their costs determined, and financing for SOE inefficiencies reduced. Scope exists to reduce the fiscal burden of SOE subsidies, which totaled 6.4% of the RMI GDP in FY2015, significantly higher than in comparator North Pacific economies.³³ Under a conservative scenario, if SOE subsidies in the RMI are gradually reduced to 5.9% of GDP by FY2020 and maintained until FY2022 through reforms, project benefits can reach \$5.1 million. The project-related benefit-to-cost ratio is estimated at 2.2:1.0. This excludes other efficiency gains in government expenditure through PFM improvements that are more difficult to quantify. The project is thus considered economically beneficial, particularly given potentially large second-order effects on broader economic growth and social welfare from improvements in the quality and efficiency of public expenditure. Ensuring reforms are sustainable may require further development partner assistance after project closure (para. 26).

B. Governance

29. **Financial management.** A project financial management assessment was prepared for the MOF, which indicated that the overall pre-mitigation financial management risk was substantial. Various weaknesses were identified that could affect project implementation (para. 4). Once the RCU is established, qualified consultants will work closely with the MOF to implement PFM reforms and provide institutional support to the MOF, thus helping to mitigate inherent risks. To mitigate control risks, ADB will generally pay international consultants using direct payment procedures. The RCU will prepare invoices and withdrawal applications for MOF review prior to ADB endorsement. An advance account will be set up, and administered by the MOF with RCU assistance. The advance account ceiling will not exceed \$100,000, and will generally be used for small payments (e.g., training materials, workshops, project operational expenses, and remuneration of national consultants). The MOF will cause detailed consolidated project financial statements to be audited by an independent auditor acceptable to ADB, and in accordance with International Standards on Auditing and the government's audit regulations. The audited project financial statements together with the auditors' opinion will be submitted to ADB within 6 months of the end of the fiscal year by the MOF. With these mitigation measures in place, the project financial management inherent and control risks are assessed to be moderate.

³² Economic and Financial Analysis (accessible from the list of linked documents in Appendix 2).

³³ SOE subsidies average only 0.4% of GDP in the Federated States of Micronesia, and 0.8% of GDP in Palau.

30. **Procurement.** A procurement capacity assessment of the MOF was undertaken, and found substantial overall pre-mitigation procurement risk. The following issues could affect project procurement: (i) weak external aid coordination, (ii) inadequate prior experience with international procurement of consultants, (iii) absence of reliable data on procurement contracts, (iv) insufficient capacity of staff to carry out procurement, and (v) inadequate documentation and monitoring on procurement. To mitigate risks, consultant recruitment will be delegated to ADB by the RMI authorities. Further, only individual consultants will be procured under the project, and contracts are not complex or high value. All procurement will follow ADB's Procurement Guidelines (2015, as amended from time to time) and Guidelines on the Use of Consultants (2013, as amended from time to time). With these mitigation measures in place, the project financial management inherent and control risks are assessed to be low.

31. **Anticorruption.** ADB's Anticorruption Policy (1998, as amended to date) was explained to, and discussed with, the government. ADB will conduct integrity due diligence for consultants. Anticorruption issues will be built into the training sessions provided by the RCU, as appropriate.

C. Poverty, Social, and Gender

32. The project will contribute to poverty reduction through (i) better PFM systems, which will align budget allocations with sectoral priorities, reduce fiscal deficits, and improve government capacity to deal with external shocks; (ii) increased efficiency of SOEs, which will reduce the fiscal burden of transfers, and free resources for development; and (iii) more transparent identification and funding of CSOs, which will help the government minimize the costs of inefficiencies, adjust subsidies, and contract out CSOs. Additional development resources will enable the government to meet the poverty- and access-related objectives in the National Strategic Plan, and improve the quality of education and health care, which currently absorb about half the budget. Greater resilience to shocks will benefit the poor.³⁴

33. The project is classified as having some gender elements as it promotes women's empowerment through targets for women's participation in project training activities and in MOF management positions. Of 78 staff working in the MOF as of June 2017, 39.7% are women. However, women are underrepresented in MOF management, with only 3 women (including the secretary) among the 16 occupied management positions (secretary, assistant secretary, division and/or section head) in the Majuro and Ebeye finance offices. The RCU will work with the AVI consultant on a plan to upgrade the MOF's human resources, and propose positive discrimination measures in recruitment and promotions to be discussed with the Public Services Commission (para. 17). The MOF is committed to raising the proportion of women in management above the baseline, subject to qualifications. In the hiring of RCU consultants, the project will encourage the selection of qualified women. The RCU will be tasked with ensuring and monitoring that women make up at least 35% of trainees in training sessions they organize for the MOF and relevant line ministries and/or agencies (para. 18). Biannual progress reports prepared by the RCU will include gender-disaggregated data and report on gender actions.

D. Safeguards

34. In compliance with ADB's Safeguard Policy Statement (2009), the project is classified as category C for the environment, indigenous peoples, and involuntary resettlement, because the project proposes only advisory inputs.³⁵ No civil works are planned, and there is no potential for

³⁴ The National Strategic Plan themes include empowering people and communities to reduce the incidence of "access related" poverty through social, economic environment, governance, and infrastructure improvements, and provision of necessary services to outer island residents to enable all RMI citizens to enjoy a high quality of life.

³⁵ ADB. Safeguard Categories. <https://www.adb.org/site/safeguards/safeguard-categories>.

involuntary land acquisition resulting in physical and economic displacement. The dominant population of the RMI is indigenous to the islands, and project activities are designed for the entire economy, with no differentiation in benefits accruing to any group. In the absence of any civil works, there will be no environmental impacts.

E. Summary of Risk Assessment and Risk Management Plan

35. Significant risks and mitigating measures are summarized in Table 4 and described in detail in the risk assessment and risk management plan.³⁶

Table 4: Summary of Risks and Mitigating Measures

Key Processing Issues	Proposed Approaches and/or Mitigation Measures
External shocks divert political and administrative attention and capacity away from reforms.	The project supports the government to build fiscal resilience. However, large external shocks can disrupt reforms. ADB will respond in a timely manner and in coordination with partners to government requests for assistance if unforeseen events occur.
Non-availability of good consultants on time for the RCU undermines reform efforts.	The government has delegated consultant selection to ADB, and suitable candidates with appropriate experience will be encouraged to apply for RCU positions. RCU remuneration under the project will be set to attract good quality consultants. Advance contracting will be undertaken.
Lack of or delays in partner TA delivery impede reform implementation.	Timely TA from development partners is critical to support the government in reform identification, design, and implementation. Regular TA coordination meetings will be organized through the RCU to mobilize and deploy resources.

ADB = Asian Development Bank; RCU = reform coordination unit; TA = technical assistance.

Source: Asian Development Bank.

III. ASSURANCES

36. The government and the MOF have assured ADB that implementation of the project shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and draft grant agreement.

37. The government and the MOF have agreed with ADB on certain covenants for the project, which are set forth in the draft grant agreement.

IV. RECOMMENDATION

38. I am satisfied that the proposed grant would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the grant not exceeding \$2,000,000 to the Republic of the Marshall Islands from ADB's Special Funds resources (Asian Development Fund) for the Public Financial Management Project, on terms and conditions that are substantially in accordance with those set forth in the draft grant agreement presented to the Board.

Takehiko Nakao
President

21 September 2017

³⁶ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned with			
More effective governance achieved ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome Public financial management improved	<p>By the end of 2021:</p> <p>a. Country performance assessment score for quality of budgetary and financial management increased by 0.5 points (2016 baseline: 3.0)</p> <p>b. Number of D/D+ scores in PEFA falls by six or more^b (2012 baseline: 21 of 35)</p> <p>c. Fiscal transfers to SOEs decline to 5.9% of GDP (2015 baseline: 6.4% of GDP)</p>	<p>a. ADB annual report on the country performance assessment exercise</p> <p>b. PEFA report or equivalent assessment</p> <p>c. International Monetary Fund Article IV reports</p>	External shocks divert political and administrative attention and capacity away from reforms.
Outputs 1. The MOF's institutional capacity to implement the PFM Reform Roadmap strengthened	<p>By the end of 2020:</p> <p>1a. At least six road map reforms implemented, as per updated road map action plan (2017 baseline: Not implemented)</p> <p>1b. At least three training sessions per year provided by the RCU, with women comprising at least 35% of trainees (2017 baseline: Training not provided)</p> <p>1c. Shares of MOF male and female staff in position holding accounting, computers, or business administration degree and/or diploma increases (2017 baseline: 38.2% of male staff and 45.1% of female staff in position)</p>	<p>1a. Certification by the MOF (by means of Cabinet orders, government decisions, MOF memoranda, as appropriate), and corroborated by development partners</p> <p>1b. Biannual progress reporting by the RCU</p> <p>1c. Biannual progress reporting by the RCU</p>	<p>Lack of timely availability of good consultants for the RCU undermines reform efforts.</p> <p>Lack of or delay in partner technical assistance to support implementation of PFM Reform Roadmap or MOF human resources upgradation plan undermines reform pace.</p>

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
2. The MOF's institutional capacity to implement SOE reforms strengthened	<p>1d. Share of women staff in MOF management positions (secretary, assistant secretary, division and/or section head) increases, subject to qualifications (2017 baseline: 18.7% of staff in position)</p> <p>By the end of 2020:</p> <p>2a. SOE monitoring unit established and staffed within the MOF (2017 baseline: Not established)</p> <p>2b. Report prepared, identifying and assessing legitimacy and cost of CSOs for at least 4 selected SOEs (2017 baseline: Not prepared)</p>	<p>1d. Biannual progress reporting by the RCU</p> <p>2a. Cabinet or ministerial decision, or equivalent</p> <p>2b. Copy of report</p>	
Key Activities with Milestones			
<p>1. The MOF's institutional capacity to implement the PFM Reform Roadmap strengthened</p> <p>1.1 Contract consultants under project grant by Q4 2017.</p> <p>1.2 Prepare prioritized and updated action plan based on PFM Reform Roadmap by Q2 2018.</p> <p>1.3 Prepare a training plan (for training to be provided by the RCU) for the MOF and other relevant government agencies by Q2 2018, including gender targets and actions.</p> <p>1.4 Provide PFM policy and technical advice and capacity development through RCU (Q1 2018–Q4 2020).</p> <p>1.5 Report to the MOF (and ADB through the MOF) on RCU performance by Q2 2018, Q4 2018, Q2 2019, Q4 2019, Q2 2020, and Q4 2020.</p> <p>2. The MOF's institutional capacity to implement SOE reforms strengthened</p> <p>2.1. Prepare report on CSO costs and legitimacy by Q3 2018.</p> <p>2.2. Establish SOE monitoring unit within the MOF by Q3 2018.</p>			
Project Management Activities			
<p>Continue regular monitoring and supervision until Q4 2020 (ADB and MOF).</p> <p>Manage contracts from Q4 2017 until Q4 2020 (MOF, with ADB support).</p> <p>Provide timely biannual progress reports until Q4 2020 (RCU to MOF, and to ADB through the MOF).</p> <p>Carry out regular accounting and annual audits (MOF).</p>			
Inputs			
<p>ADB: \$2.0 million (grant)</p> <p>Government of the Marshall Islands: \$0.3 million (in-kind contributions)</p>			
Assumptions for Partner Financing			
Not applicable			

ADB = Asian Development Bank, CSO = community service obligation, GDP = gross domestic product, MOF = Ministry of Finance, PEFA = public expenditure and financial accountability, PFM = public financial management, Q = quarter, RCU = reform coordination unit, SOE = state-owned enterprise.

^a Government of the Marshall Islands. 2014. RMI National Strategic Plan 2015–2017. Majuro.

^b For the PEFA assessment and scoring methodology, please visit the PEFA resource center (<https://pefa.org/>).
Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=50295-001-2>

1. Grant Agreement (Special Operations)
2. Sector Assessment (Summary): Public Sector Management
3. Project Administration Manual
4. Contribution to the ADB Results Framework
5. Development Coordination
6. Economic and Financial Analysis
7. Country Economic Indicators
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan

Supplementary Document

10. Summary Human Resource Assessment for the Ministry of Finance