

**REPORT AND RECOMMENDATION  
OF THE  
PRESIDENT  
TO THE  
BOARD OF DIRECTORS  
ON  
PROPOSED LOANS  
TO THE  
FEDERATED STATES OF MICRONESIA  
FOR THE  
PRIVATE SECTOR DEVELOPMENT PROGRAM**

**November 2001**

## CURRENCY EQUIVALENTS

The Federated States of Micronesia uses the US dollar as its currency.

## ABBREVIATIONS

ADB	–	Asian Development Bank
BDC	–	Business Development Council
COM	–	College of Micronesia
DEA	–	Department of Economic Affairs
DOF	–	Department of Finance and Administration
EPIC	–	Economic Policy Implementation Council
FSM	–	Federated States of Micronesia
FSMDB	–	Federated States of Micronesia Development Bank
FY	–	fiscal year
GDP	–	gross domestic product
km <sup>2</sup>	–	square kilometer
MEDC	–	Micronesian Entrepreneur Development Center
NGO	–	nongovernment organization
PIU	–	Program-Project Implementation Unit
PSDP	–	Private Sector Development Program
PSE	–	public sector enterprise
PSRP	–	Public Sector Reform Program
SBDC	–	Small Business Development Center
SME	–	small and medium enterprises
SOE	–	statement of expenditures
TA	–	technical assistance
UNDP	–	United Nations Development Programme
UNIDO	–	United Nations Industrial Development Organization
US	–	United States

## NOTES

- (i) The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2001 ends on 30 September 2001.
- (ii) In this report, "\$" refers to US dollars.

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## **LOAN AND PROGRAM SUMMARY**

<b>Borrower</b>	Federated States of Micronesia (FSM)
<b>The Proposal</b>	Loans for the Private Sector Development Program (PSDP) will support economic and legal reforms and strengthen the institutional infrastructure to promote private sector development.
<b>Rationale</b>	The FSM has embarked on a program of economic reforms to reduce the role of the public sector in the economy and increase economic self-reliance. Substantial cuts in the size of Government have been achieved but structural change to achieve greater private sector employment and development is slow to occur due to fundamental constraints in the FSM's legal and institutional infrastructure. Assistance is needed to help the FSM establish an open and competitive economy that is conducive to private sector development by (i) promoting a favorable economic and legal environment for investment; and (ii) increasing the mobilization, productivity, and competitiveness of FSM's land, labor, and capital resources.
<b>Classification</b>	Economic growth, private sector development
<b>Environmental Assessment</b>	Category C. Environmental implications of the proposed policy and institutional reforms were reviewed; environmental interventions have been incorporated, as required.
<b>The Sector Development Program</b>	
<b>Objectives and Scope</b>	The goal of the PSDP is to promote economic growth by expanding the private sector in the FSM, thereby raising domestic employment and incomes and reducing dependence on external assistance. To attain this goal, the objectives of the PSDP are to (i) improve the policy and legal environment for private sector development; and (ii) strengthen capacity to manage land, labor, and capital resources.

The PSDP will have a national and state focus, in particular, on states and groups where income inequality is more pronounced. The Program is tailor-made to meet individual states' needs. The PSDP includes (i) a policy framework and actions and (ii) an investment project aimed at improving performance of the public services to promote private sector development. The investment project will (i) establish a secured transaction system; (ii) provide institutional capacity building for land administration and management, in particular, land titling, financial support to small- and medium-sized enterprises, and business development support; and (iii) strengthen the capacity for coordinating and monitoring the PSDP.

### **The Policy Loan**

#### **Loan Amount and Terms**

\$5.0 million equivalent will be provided from Asian Development Fund of the Asian Development Bank (ADB). The program loan will have a maturity of 24 years including an 8-year grace period, 1 percent interest charge during the grace period and 1.5 percent during the amortization period, and equal amortization.

#### **Program Period and Tranching**

The policy loan will be utilized over three years commencing in February 2002; completion is expected by February 2005. The loan will be disbursed in two tranches. The first tranche will be made available upon loan effectiveness. The second tranche will be released some 18 months later upon compliance with conditions for its release.

#### **Executing Agency**

The Department of Finance and Administration (DOF) will be the Executing Agency.

#### **Procurement**

The proceeds of the policy loan will be disbursed against a broad range of imports, subject to a negative list. Eligible imports incurred up to 180 days prior to loan effectiveness may be reimbursed from the proceeds of the loan.

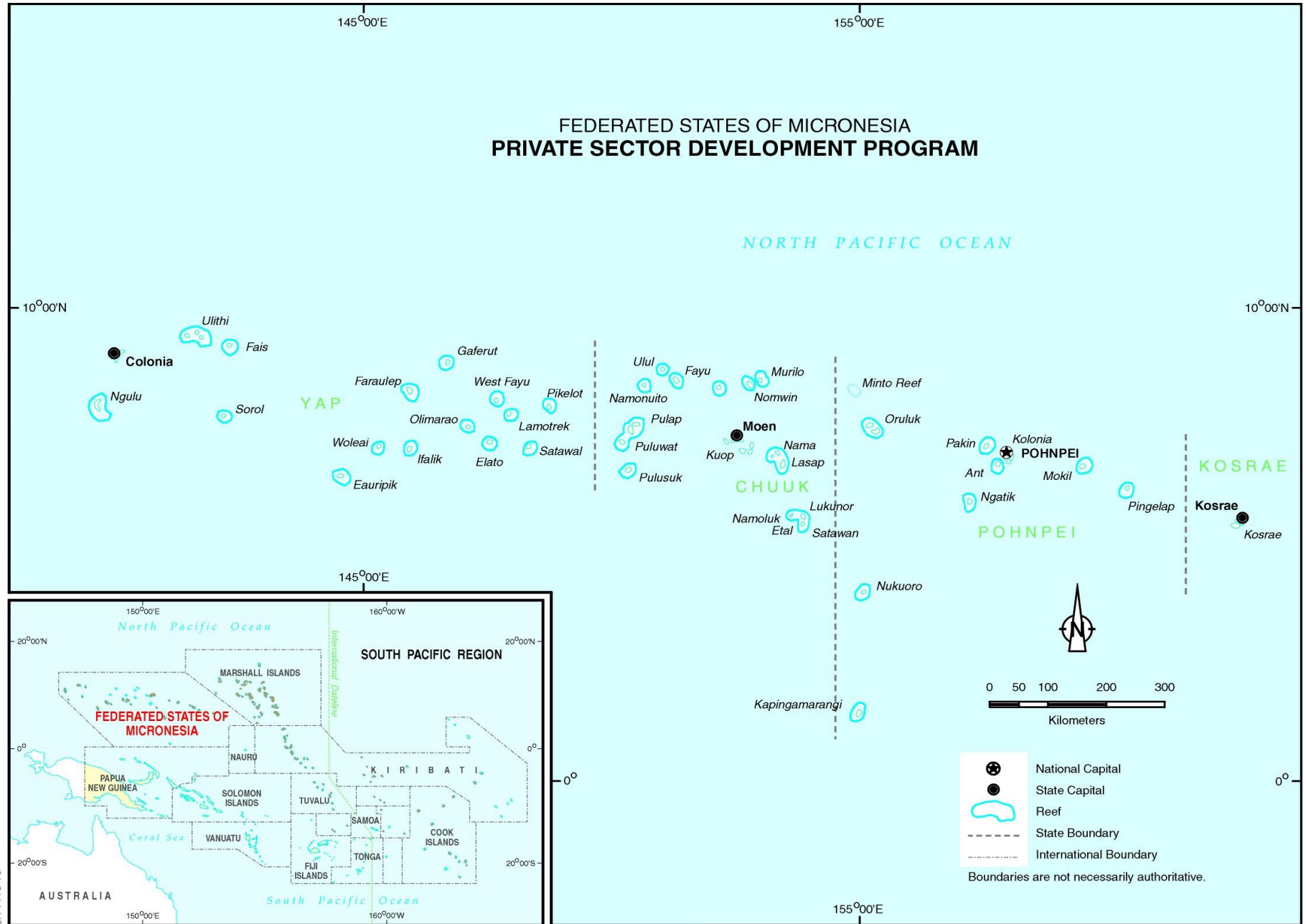
#### **Counterpart Funds**

The counterpart funds to be generated from the proceeds of the policy loan will be used by the Government consistent with the economic and legal reforms for promoting private sector development as agreed.

## The Investment Loan

<b>Loan Amount and Terms</b>	\$8.017 million equivalent will be provided from ADB's Asian Development Fund. The loan will have a maturity of 32 years including an 8-year grace period, 1 percent interest charge during the grace period and 1.5 percent during the amortization period, and equal amortization.
<b>Executing Agency and Implementation Arrangements</b>	DOF will be the Executing Agency. The Department of Economic Affairs (DEA) will be the Implementing Agency. The state governor's offices will be the implementing agencies at the state level. A steering committee, co-chaired by the Secretary of Finance and the Secretary of Economic Affairs, and to include the governors of the states or their representatives and a representative for each of the COM and FSMDB, shall be established to monitor and coordinate the Program and the Project.
<b>Procurement and Consulting Services</b>	Contracts for equipment and supplies estimated to exceed \$500,000 and contracts for civil works estimated to exceed \$1.0 million will be awarded on the basis of international competitive bidding as detailed in ADB's <i>Guidelines for Procurement</i> . Contracts of lower value will be procured on the basis of local competitive bidding, international shopping, or direct purchase as per ADB's <i>Guidelines for Procurement</i> . Consultants will be recruited through a firm or as individuals in accordance with the ADB's <i>Guidelines on the Use of Consultants</i> and other procedures acceptable to ADB for the selection of domestic consultants.
<b>Time Frame</b>	The Project will be implemented over four years commencing in February 2002, with completion expected by February 2006.
<b>Risks and Safeguards</b>	The principal risks are (i) lack of political will for economic and legal reforms, (ii) ineffective public administration to carry out the PSDP, (iii) weak response from the private sector to the policy and legal reforms and investments, and (iv) affordability and sustainability of the PSDP. Specific arrangements have been worked out with the Government to mitigate these risks to ensure that the private sector-led economic growth program can be sustained.

FEDERATED STATES OF MICRONESIA  
**PRIVATE SECTOR DEVELOPMENT PROGRAM**



## **I. THE PROPOSAL**

1. I submit for your approval the following Report and Recommendation on two proposed loans to the Federated States of Micronesia (FSM) for the Private Sector Development Program.

## **II. INTRODUCTION**

2. At the request of the FSM Government, the Asian Development Bank (ADB) approved technical assistance (TA)<sup>1</sup> in October 1999 to assist the Government in preparing a private sector development program (PSDP). The Government's request for the proposed PSDP loan resulted from the Second FSM Economic Summit held in September 1999, which defined private sector development as the overarching national development goal.<sup>2</sup> ADB agreed to consider the request, as it fitted in with the revised Pacific Strategy<sup>3</sup> and initiated loan processing in 2000 for approval in 2001. Accordingly, the ADB loan Fact-Finding Mission was fielded during 24 May-9 June 2000 and followed up by an appraisal mission in September 2000. The missions visited all four FSM states, and discussed the policy and investment components identified under the TA. The national and state governments expressed strong interest in and support for the PSDP. Appropriate draft legislation was submitted in late 2000 to the FSM Congress. Consideration of the PSDP loan by the FSM Congress was delayed to allow adequate time for all four states to participate and reach a level of ownership that will ensure sustainability of the program. To augment this process, a country programming and consultation mission visited the FSM from 18 to 31 July 2001. The mission revalidated and updated the PSDP loan documents, as well as held consultations with the states and the national Government to ensure that all states are able to meet the conditions of and participate in the proposed PSDP loan. Legislation to borrow for the PSDP loan is expected to be acted upon in the November 2001 session of the FSM Congress. The program framework for the PSDP is in Appendix 1.

## **III. BACKGROUND**

### **A. Macroeconomic Context**

#### **1. Development Potential and Economic Prospects**

3. The FSM comprises more than 600 islands totaling 702 square kilometers (km<sup>2</sup>) of land area scattered over an exclusive economic zone of 2.6 million km<sup>2</sup> in the western central Pacific Ocean. The islands are divided among four states: Chuuk (133.8 km<sup>2</sup>), Kosrae (117.4 km<sup>2</sup>), Pohnpei (360.6 km<sup>2</sup>), and Yap (125 km<sup>2</sup>) with the national government located in Pohnpei at Palikir. Island landforms vary from high islands with extensive tropical forests and substantial areas suitable for agriculture to narrow atolls. The ocean area of the FSM's exclusive economic zone is the country's greatest natural resource. Estimates<sup>4</sup> indicate that the western Pacific could support annual catches of at least 0.4 million tons of skipjack tuna, and 0.65 million tons of yellow fin tuna, but the sustainable catch of bigeye tuna and albacore is fully exploited. The FSM's natural beauty and reasonable proximity to Guam, Palau, and the Philippines places it well to capitalize on the growing tourism to the region from Asia, especially Japan; the United

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<sup>1</sup> TA 3278-FSM: *Private Sector Development Program*, for \$150,000, approved on 19 October 1999.

<sup>2</sup> Through TA 3024-FSM: *Economic Policy Reform and Management (EMPAT II)*, for \$2,877,000, approved on 12 May 1998, ADB provided economic advisory support to, and participated in, the Summit.

<sup>3</sup> ADB. 2000. *A Pacific Strategy for the New Millennium*. Manila.

<sup>4</sup> ABD 1996. FSM Economic Report. Manila.



States (US); Australia; and Europe. But the FSM's small population (111,500 persons in 1998), limited land area, and relative isolation from markets limit its capacity to take advantage of some of the opportunities presented. In the main centers of each state, basic economic infrastructure, including roads, airports, ports, access to telecommunications, electricity, water, and other utilities is of reasonable quality and reliability. Outside the main centers, the state of completion and durability of infrastructure are still variable.

4. The FSM's political and economic ties with the US through the Compact of Free Association, a treaty agreement, places the country in a unique situation. While the treaty was drafted to last indefinitely, provisions under Title Two, Economic Relations, are time bound and due to expire in FY2001. The Compact allows for annual cash grants (in nominal terms) averaging \$98 million for FY1987/91, \$90 million for FY1992/96, and \$79 million for the third five-year period FY1997/2001. A significant amount of grant transfer contributed to notable average real gross domestic product (GDP) growth of 4.2 percent during FY1987/95 mainly based on large government spending. However, the two step-downs of Compact funding have required fiscal austerity and led to negative economic growth averaging minus 1.5 percent during FY1995/2001. Facing the second step-down in the Compact funding starting in 1996, the FSM launched public sector and economic reforms, supported by an ADB program loan.<sup>5</sup> An important component of the Public Sector Reform Program (PSRP) involved reducing the size and operating costs of government.

5. At the time of the 2000 annual census, FSM had a total population of 107,008.<sup>6</sup> Chuuk is the most populous state with 53,595. From 1989 to 1994, the population grew at an average of 1.96 percent per annum. However, due largely to increased out-migration, the annual rate from 1994 to 2000 was just 0.24 percent. In 2001, 40.3 percent of the population was aged 0–14. The dependency level is very high, especially from the young, raising the income requirements for the average family and lowering per capita incomes. A crude estimate indicates that a projected annual growth rate of over 12 percent is needed by the economy to absorb the currently unemployed and upcoming entrants to the labor market. This is a daunting prospect considering the recent contractions in GDP and real growth levels of 1.1 percent in FY1999, 2.5 percent in FY2000, and 0.9 percent in FY2001.

6. To cope with these macroeconomic and demographic challenges and to exploit the FSM's economic potential, a response by the private sector is critical. If the country is to become more resilient to external shocks and to create even a portion of the employment needed to absorb public sector retirees, the unemployed, and the upcoming influx of youth, the country should pursue private sector-led economic growth. However, many of the conditions that are essential for private investment and economic growth need to be improved urgently. The country's legal systems and public institutions' ability to manage and support the markets for private land, labor, and capital remain inadequate. Without internal market infrastructure that can attract, utilize, and circulate these resources, any bank or other externally-supplied capital and skills will be less effective in supporting sustained economic growth.

## **2. Economic Performance and Developments**

7. Real GDP estimates indicate that the FSM economy as a whole has grown at an annual average rate of 1.8 percent from \$169 million in 1987 to \$218 million in 2001 (all in FY1998

<sup>5</sup> Loan 1520-FSM: *Public Sector Reform Program*, for \$18.0 million, approved on 29 April 1997 and completed on 31 December 1999.

<sup>6</sup> DEA. 1998. Household Income and Expenditure Survey. Division of Statistics.

constant terms). Underlying this positive but modest growth are the fundamental effects of the resource transfers from the US prior to and following the Compact agreement, and the major role government has assumed in the economy. During the second half of the 1990s, the FSM economy slumped, as US transfers declined, necessitating downward adjustments in government expenditure, and as the private sector, significantly dependent on government spending, began to adjust. The FSM economy as a whole contracted at an annual rate of minus 1.5 percent during FY1995/2001. However, the economy appears to have bottomed out; it grew by about 1.1 percent in FY1999, 2.5 percent in FY2000, and 0.9 percent in FY2001.

8. The real GDP per capita in FY2000 is estimated at \$2,036, which places the FSM in the middle income group of ADB's 12 Pacific developing member countries. The difference in economic performance by state is significant. Real GDP per capita of Chuuk (\$1,170) was one-third of Yap (\$3,215) in FY1999. Overall GDP growth was strongest during FY1987/2001 in Pohnpei (3.0 percent), Yap (2.9 percent), and Kosrae (0.6 percent), while GDP declined slightly in Chuuk (minus 0.2 percent). As the effects of economic shocks set in, the FSM private sector declined from FY1995/2001 by minus 1.6 percent per annum; however, among the states, only Pohnpei experienced a decline in private sector activity during this period of minus 4.8 percent per annum.

9. Over the first five-year period under the Compact transfers, FSM-wide government expenditure increased by 62 percent from \$104 million in FY1987 to \$170 million in FY1991. In the second five-years of funding, deficit spending using surpluses from previous years created the circumstances for the difficult adjustments that followed the second step-down in Compact funding. Painful adjustments were made by the five governments of the FSM through the PSRP. This included a reduction in the FSM-wide government workforce of 23 percent, and wage cuts and restraint to effect payroll savings of \$17 million per year or a reduction of 29 percent. Government spending fell from more than 100 percent of GDP, during FY1989/91 to 66 percent in FY2000. Consolidated FSM Government revenues, including Compact transfers, and expenditures are close to balancing.

10. Prior to FY1990, the FSM had no official public debts to offshore lenders. During FY1990/1993, borrowing increased to a peak of \$137 million in FY1993, representing 66 percent of GDP. The borrowing included \$71 million for Yap State's monetization program, \$42.9 million for fisheries investments through the state and national fisheries enterprises, as well as public guaranteed borrowing for telecommunications (\$41 million) and fisheries in Yap (\$9 million). Since FY1993, the only new borrowing has been from ADB, including fisheries development,<sup>7</sup> the PSRP (footnote 5), and water supply and sanitation.<sup>8</sup> Disciplined debt servicing has allowed the debt to fall to slightly over \$80 million in 1999 and is expected to fall to 24 percent of GDP by FY2001. Nonetheless, the uncertainties over the future of US economic transfers including the form, amount, and conditions of the assistance are not likely to be known until 2003. Given the lack of knowledge of future financial and economic assistance from the US, the FSM governments prefer to take a cautious approach to bearing additional debt over the short term. Regardless of the result of the new Compact renewal, the Government needs to stay the course of reforms and to improve the enabling environment for private sector development, an engine of growth, so that new US assistance will contribute to building a more self-reliant economy.

<sup>7</sup> Loan 1257-FSM: *Fishery Development Project*, for \$6.4 million, approved on 19 October 1993.

<sup>8</sup> Loan 1459-FSM: *Water Supply and Sanitation Project*, for \$10.2 million, approved on 19 September 1996.

### **3. Incidence of Poverty**

11. The incidence and nature of poverty in the FSM is unclear given the lack of specific data, but the United Nations Development Programme (UNDP) human poverty index of 26.7 indicates the FSM has the fourth highest level of poverty among the Pacific developing member countries. A tentative head-count estimate of poverty for the FSM uses the latest household income and expenditure survey of 1998. The preliminary estimate is that about 40 percent of all FSM families live below the food threshold; about \$575 is required for a family to consume the minimum required number of calories. Similarly, based on the average proportion a family spends on food as a share of total income, about 40% of all FSM families live below the overall poverty threshold of \$1,075. Variation in poverty is substantial between the states, the poorest being Chuuk with a poor population of 53 percent and Yap, the least poor, with 16 percent. Income in Yap is also better distributed, with the ratio of mean income of the highest 20 percent of households to the lowest 20 percent being 7.3, as against 13.3 for Pohnpei, which has the highest income inequality. Larger households tend to be poorer than small households. A higher proportion of households headed by women tends to be poor (43.7 percent, as compared with 39.6 percent for men and 40.4 percent overall).

12. A range of social problems, including high dependency ratio and high population growth (2.3 to 2.5 percent natural growth rate) compared with economic growth, low educational attainment and poor education services, increased unemployment arising from government downsizing, limited formal employment opportunities in the private sector, and reduced government budgets for social services place the FSM at risk of social decline and an increased incidence of poverty. The greatest risk is in Chuuk State, which has the lowest per capita GDP. Groups that are at the greatest risk include locationally disadvantaged outer islanders and people residing far from main centers (an estimated 17 percent of the population or 18,000), migrants to the main islands,<sup>9</sup> school dropouts, unemployed youth, and dislocated public sector workers with inappropriate skills for the private sector. Micronesian society can offset some of the impact by drawing upon the obligations of the extended family, but this also places a burden on the income earners, further straining low household incomes. Recent successive economic contractions suggest that the already low standards of education, health, and law enforcement will decline, having a negative impact particularly on the outer islanders and migrants to the main islands who are virtually landless.

## **B. Sector Description and Recent Performance**

### **1. The Role of the Private Sector in Gross Domestic Product**

13. The largest single sector in the FSM economy is government services. Although the contribution of government services to GDP has fallen from 36 percent of GDP in FY1987 to 23 percent in FY2001, this is still high by international standards, including other Pacific countries. The second largest sector is wholesale and retail trade, which has grown largely in response to the spending power of salaried government workers. Subsistence production from agriculture and inshore fisheries is estimated to be the third largest sector. Subsistence production, therefore, still makes a significant contribution to the economy through informal activity outside the market economy.

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<sup>9</sup> In Pohnpei State, over 2,000 outer islanders have settled on the main island of Pohnpei, while 5,000 outer islanders have settled on the small island of Weno, the state capital of Chuuk (ADB. 1993. Women in Development Study, Country Briefing Paper. Manila.).

14. Until FY1990, the public sector contributed a larger amount to GDP than the private sector. Since 1989, the private sector contribution began to exceed the public sector. In FY1998, the contribution of the formal private sector to GDP was 31 percent, and subsistence contributed 14.0 percent. The combined private sector activity has contributed more to the economy than the government every year since FY1991 and grew at an average annual rate of 7.2 percent from 1987 to 1995. Between FY1995 and FY2001, the contribution of the government to GDP fell by 7.7 percent annually, whereas private sector activity fell by an average 1.6 percent annually.

## **2. The Structure of the Private Sector**

15. If the market economy alone is considered, that is contributions to GDP from private and public enterprises excluding government services and subsistence production, then the dominance of the wholesale and retail trade is even more pronounced. An estimated 51 percent of the market economy arises from wholesale and retail trade, while the two major export sectors, fisheries and tourism, account for only 11 percent. Commercial agriculture is even smaller, representing only 2 percent of the market economy. This indicates that the private sector, in its current form, is dominated by nontraded goods and services that can only be sold and bought within the domestic economy, such as wholesale and retail goods, rental property, and services to support government operations. The 1996 survey of businesses indicates that wholesale and retail trade dominated the formal sector in terms of number of establishments (57.8 percent), employment (49.3 percent), wages (27.6 percent), and value added (55.8 percent).

16. The reason for an economic structure based largely on nontraded goods and services stems from the creation of a government sector that became the largest employer in the FSM and the resulting higher relative cash incomes in that sector. As a result, lifestyles have changed as reflected in the increased demand for imported foods and products, which became more affordable and preferred for their convenience. The private sector responded by expanding into the lucrative wholesale and retail businesses. Furthermore, as government employment provided a satisfactory income as an alternative to the relatively high-labor-demanding subsistence and small-scale commercial agriculture and fisheries sectors, the relative returns dropped for resources used in agriculture and coastal fisheries. This has resulted in decreased use and production of a variety of domestic products, especially in subsistence and small-scale commercial agriculture and fisheries. Even ocean fisheries (tuna), despite the high value of fish exports, currently make only a small contribution in terms of value added to the economy.

17. Under a situation of US economic assistance step-downs and government downsizing, the greatest negative economic impact has been on businesses dealing with nontraded goods and services. As wholesale and retail is the largest sector in the market economy, initially this sector will be at greatest risk. Because the FSM economy has grown based on an inward-looking strategy in terms of products and markets, the FSM's relative competitiveness in the world market is weak. To become more resilient to future changes in transfers and to reduce the current levels of dependence on government-directed and -financed development, the tradable sector must be expanded through private sector activity.

## **3. Enterprises, Employment, and Wages in the Private Sector**

18. Commercial and business activity is dominated by informal and formal small- and medium-sized enterprises (SMEs). Apart from the government and utilities corporations, few large businesses exist that can create major employment or single markets for other

businesses. As such, most small businesses in the FSM can be characterized as having a small market share, and personalized owner operator or family management, that is too small to gain access to commercial banking services. In 1998, an estimated 2,000 formal and informal SMEs were operating in the four states (600 in Chuuk, 300 in Kosrae, 800 in Pohnpei, and 300 in Yap).<sup>10</sup> Excluding occasional sales from subsistence production, SMEs comprise more than 90 percent of the total number of enterprises, and employ about 9,500 of a potential labor force of 59,000. Hence, any meaningful and effective intervention for private sector development in the FSM will have to consider the important role SMEs play in the economic and social development of the country.

19. The informal sector plays an important and often unacknowledged role in the FSM economy. The majority of the FSM population live in rural areas including outer islands and engage in subsistence and mixed subsistence production for their livelihood. The FY2001 in-kind income from subsistence was \$33 million compared with formal private sector wages and profits of \$71 million. Given the limited opportunities for earning cash incomes in the formal sector, the subsistence and informal sectors continue to support an increasing number of people. The sale of surplus subsistence production from agriculture and inshore fisheries provides a useful and significant contribution to livelihoods, especially for nonsalaried persons. Informal sales of subsistence production in 1998 were estimated at \$9.1 million inclusive of exports of local agricultural produce of under \$2 million (footnote 6). Such informal sales are often the basis from which commercialization through the informal sector occurs. This is especially evident in Truk Lagoon of Chuuk State, where the combined sales of fresh and processed local foods (agricultural and fisheries) have provided the basis for well-established markets in Weno. Part of this produce is exported to Guam. An increasing focus is needed on enhancing the capacity of the subsistence and informal sectors to encourage "graduation" into the formal private sector enabling the generation of employment opportunities. Experience shows that the informal sector is an important source of entrepreneurial talent, particularly of women.

20. The FSM's labor market faces a number of major problems and constraints including (i) a demographic imbalance that will require a rapid expansion of the job market in the near future; (ii) a formal elementary and secondary education situation that is generating a high proportion of dropouts; (iii) lack of wage competitiveness; and (iv) limitations in the ability of the labor market and institutions to provide skilled labor. The high dependency level means the average family needs more income to survive. Even though out-migration to the US is expected to have increased in recent years, in effect reducing the population growth rate, this will not redress the high dependency ratio. A response by the private sector, supported by a more favorable investment and pro-private-sector climate, is critical if the economy is to grow and create even a portion of the employment needed to absorb the public sector retirees, the unemployed and underemployed, and the upcoming influx of youths about to enter the job market. The informal sector and even out-migration of Micronesians who are better trained for the overseas job market are an integral part of the overall need to raise gainful employment in the population.

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<sup>10</sup> In 1994, the UNDP/United Nations Industrial Development Organization (UNIDO)-assisted Micronesian Entrepreneur Development Center program proposed a bill to the Pohnpei Legislature, the Business Development Act of 1994, which became law on 10 January 1995. The law defines SMEs as any business activity or enterprise engaged in industry, agribusiness, tourism, trade, and/or industrial and business services, whether single proprietorship, cooperative, partnership, or corporation whose total assets inclusive of those arising from loans but exclusive of the land on which the particular business entity's office, plant, and equipment are situated, must have value falling under the following categories: Cottage: Less than \$5,000; Small: \$5,001 to \$25,000; or Medium: \$25,001 to \$250,000.

21. The fact that public sector wages are almost double that of the private sector has two major effects. First, higher public sector wages have attracted scarce qualified people to government over the private sector, and acted as a disincentive to private sector employment. Second, pay levels have been pushed up due to the large and relatively better paid government. The resulting high labor costs for the private sector have increased overall production costs in the private sector, and reduced competitiveness of the sector especially if higher wages are not matched with increased productivity. An important first step in adjusting the labor market through downsizing and pay restraints in favor of private sector development was the implementation of the PSRP. Nevertheless large differences in pay levels and conditions still exist, and continue to favor public sector employment, divert skilled labor away from the private sector, and undermine the competitiveness of the private sector through higher wage expectations. However, adjustment of wage differentials alone is not sufficient.

22. Education attainment is essential for expanding private sector employment. While a large government will have increased skills necessary for public services, these are not necessarily suitable for private sector activity. As literacy and numeracy achievement at the elementary level is low, the majority of the population are ill-prepared for employment by the private sector, which often requires basic skills such as English language communication, and in many cases even unskilled work. The current labor market situation is still limited by its inability to provide domestic skilled labor needed by the private sector, and skill gaps continue to prevail.

### **C. Constraints and Issues**

23. A survey conducted by the Forum Secretariat<sup>11</sup> revealed that significant impediments to foreign investments commonly exist in the Pacific island countries. The most significant impediments are (i) bureaucratic delays; (ii) changes in government policies; (iii) land tenure issues related to the adjudication, survey, registration, and issuance of land titles; and (iv) lack of administrative skills in dealing with foreign investment matters. In addition to these policy and regulatory impediments, overall economic prospects of the country and labor skills were identified as other factors affecting investment. The investors raised virtually no concerns about infrastructure. ADB TA for preparing the PSDP and the TA's own survey in December 1999 on SMEs confirm the major findings of the Forum Secretariat's survey, as well as particular constraints to development of the private sector in the FSM (footnote 1).

#### **1. Fragile Policy and Regulatory Environment**

##### **a. Need for Consolidating Public Sector Reforms**

24. Through the ADB-funded PSRP, the national and state governments successfully implemented financial adjustments and government restructuring. However, since the completion of the PSRP in 1999, the governments are facing pressure to rehire staff and raise government wage levels. Furthermore, despite the wage cuts in the government sector under the PSRP, FSM public sector wages are almost double that of the private sector on average. This continues to favor public sector employment and undermine the competitiveness of the private sector through higher wage expectations and diversion of skilled labor. Under the current Compact agreement, if the negotiations are not concluded by 2001, then a two-year extension of the current agreement is automatically provided with annual payments calculated at an

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<sup>11</sup> Forum Secretariat. 1998. Impediments to Investment in Forum Island Countries. Suva. The survey covered foreign investors from Australia, New Zealand, United Kingdom, and the US. The surveyed investors comprised potential and recent existing investors, and the investors who have withdrawn from the Forum countries.

average of the annual payments over the first 15 years of the current agreement. This will amount to a 27.5 percent increase over the Compact base grant compared with FY2001. While this provides for short-term improvement in the FSM's fiscal situation, the Government should avoid a temporary increase in unnecessary and unsustainable spending as this could lead to an economic shock of even greater magnitude than those experienced following the two Compact step-downs.

25. Many of the FSM governments have sponsored risky, commercial operations.<sup>12</sup> While the goal of setting up these operations was to make up for the perceived capacity deficiencies of the domestic private sector, in many cases these ventures resulted in substantial financial losses for the national and state governments, and have not contributed in a meaningful manner to sustainable economic development. In addition, such sponsorship of purely commercially oriented enterprises in some cases led to crowding out of private sector activities rather than facilitating their development. Focusing public spending on production has detracted from activities and the delivery of services to remove production constraints for the private sector, such as providing information on markets, increasing know-how, and providing effective business development support.

26. As a part of PSRP reforms that began in 1997, the state and national governments have undertaken a review of the functions of several departments and public enterprises to identify activities that can be privatized, corporatized, or divested entirely. Most of the states have already transferred the major utilities of power, water, and sanitation to independent public utility authorities, which are run, more or less, on a commercial basis. Furthermore, several other activities that were part of departmental operations have been privatized or contracted out. However, the actual implementation of public enterprise reforms has seldom gone beyond commercialization and corporatization. Reasons include lack of commercial viability in their current structure, complexity in legal status including multiple national and state ownership, reluctance to accept capital write-offs, and the implications of redundancies. Some statutes create an uneven playing field with the private sector, by giving some of the public enterprises tax exemptions and other privileges. A positive step was the establishment in January 2000 of the Public Enterprise Unit within the Department of Economic Affairs (DEA) to coordinate and facilitate formulation of privatization policies and their actual implementation with support from an ADB TA.<sup>13</sup> The TA is proposing four broad categories for reform: (i) corporate governance reform, (ii) private sector participation, (iii) divestiture, and (iv) liquidation. The general national and state governments' commitment to privatization must be translated into a concrete, comprehensive policy framework and detailed time-bound action plan that will provide the basis for the actual implementation of the privatization process.

## **b. Weak Legal and Regulatory Environment**

27. In the FSM, weaknesses in the existing enabling legal and regulatory framework have proved to be an impediment to attracting and realizing investment and in some cases driven

<sup>12</sup> PSEs in the FSM can be subdivided in broad terms into four major groups: (i) utilities (telecommunications corporation of FSM, state electricity, water, sewerage, transportation companies); (ii) fishing (National Fisheries Corporation and its subsidiaries and state government-owned fishing companies); (iii) finance (Bank of FSM and FSMDB); and (iv) other miscellaneous activities, including housing authorities, broadcast stations, and coconut processing companies. Overall, public enterprises account for approximately 14 percent of formal sector GDP (1996) and employ around 1,400 people, or about 10 percent of formal sector employment [EMPAT Report on Public Enterprise Reform. Majuro. Department of Economic Affairs. 1997].

<sup>13</sup> TA 3201-FSM: *Privatization of Public Enterprises and Corporate Governance*, for \$450,000, approved on 31 March 2001.

potential investors away. The Government has recognized this and work is under way in a number of critical areas that will improve the provision of and access to economic resources, resource providers, and user security.

28. Land must be more readily available for development in the FSM both through secure access to land for production and investment activities, and as a means for mobilizing finance. A major legal obstacle is the constitutional prohibition of foreign ownership of land (nationwide), of ownership by citizens from other FSM states (Kosrae and Pohnpei), and of any sale of land (Pohnpei). Restrictions on the length of leases in each state (25 to 50 years depending on the state with provisions for renewal in most cases) may be regarded by investors as insufficient to realize an adequate or competitive return on an investment, especially in sectors such as tourism, which is in the early stages of development. As foreigners are not permitted to own land in the FSM, this limits the use of secured loans by the foreign commercial banks operating in the FSM, as they cannot arrange direct, mortgage-secured lending. The current state mortgage statutes (except Kosrae, which has only a deed of trust) lack an efficient mechanism of nonjudicial foreclosure, redemption, and other procedures for the commercial banks to take a security interest in the property including land leasehold. To address these land-related legal issues, the Government, with ADB's TA support,<sup>14</sup> has developed model long-term land lease laws and mortgage laws allowing land leasehold mortgage. These legislation drafts are deemed acceptable under the constitution and traditional land tenure system.

29. Historically, regulation of foreign investment in the FSM required lengthy, case-by-case review, and lacked transparency. This approach to foreign investment served to protect local jobs, business opportunities, incomes, and resources. Under the PSRP, foreign investment regulations were mostly decentralized and attempts were made to improve transparency and liberalize the rules of entry of foreign investors. However, the current foreign investment laws at all five FSM national and state governments continue to discourage potential foreign investors with complex application and discretionary approval systems. In May 2000, the governments reviewed the national and state foreign investment laws in May 2000 in order to improve the transparency and consistency of foreign direct investment policies. This process was jointly assisted by ADB (footnote 14) and the Foreign Investment Advisory Service. The results of the reviews need to be implemented.

30. A secured transactions law will enable lenders to effectively utilize almost any kind of property, other than land, as collateral and most especially chattels. This is important for small investors and business people wishing to start or expand informal or small businesses, as well as other investors. A short secured transactions law from the Trust Territory days has proven inadequate to protect lenders. The need for a replacement has long been recognized and a bill for establishing a nationwide secured transaction system has been prepared. The FSM does not currently have any bankruptcy law in place. In the absence of a bankruptcy law, the commercial environment loses an important element of predictability and fairness, courts are called upon to make legislative decisions, and struggling businesses, which might have succeeded, can be destroyed prematurely by creditors intent on not being the last in line. The FSM recognizes the need for national bankruptcy legislation, but such legislation lacks consensus.

## **2. Limited Access to Land and Security of User Rights**

31. The limited land area of the FSM, growing population, and increasing integration with the market economy are placing ever-increasing pressure on the traditions of ownership and call

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<sup>14</sup> TA 2758-FSM: *Improved Economic Use of Land*, for \$550,000, approved on 4 February 1997.



attention to the need for improved security of rights and land management and administration. Variable progress has been made among the four states on determining status and titling. In Yap, for example, less than 10 percent of the land has been registered and titled over the 30 years since the state cadastral program commenced, largely due to the reluctance to initiate a survey that is likely to be disputed. Kosrae has made progress toward the initial determination of land parcels, although many disputes are pending resolution and the backlogs of parcels that await completion of surveying and mapping is substantial. In Chuuk and Yap, limitations are due to the inability of the customary and formal civil systems to adjudicate and determine ownership as a prerequisite to registration and titling. Pohnpei has made the most progress with cadastral surveys of private lands, and is currently addressing a large backlog of subdivision surveys.

32. The institutions that support individual titles vary by state. In general, two government institutions administer land tenure: land commissions (Kosrae and Yap) or the Court of Land Tenure (Pohnpei), and the divisions of land management (all states). Each of these institutions has a number of capacity limitations resulting in slow titling and registration. The general use of the US land-titling system over the past 50 years was largely supply-driven, and its variable effectiveness indicates a range of problems and inefficiencies in service delivery, or inappropriate integration with traditional systems and, consequently, a low level of demand for the system in its current form. An ongoing ADB TA (footnote 14) is conducting public education on land registration law, regulations, procedures, and the benefits of registering all landholdings. In Kosrae, a bill has been introduced to strengthen the Land Commission; in Chuuk, there is an agreement in principle to merge land survey and the Land Commission to improve institutional capacity; and, in Yap, proposals have been made for time-bound dispute settlement through the municipal courts. In Pohnpei, advanced survey, mapping, and digital archive equipment were purchased under a 1996 US Department of Interior grant (approximately \$600,000), but the equipment is not being utilized to its full potential due to limitations in training and problems experienced with implementing TA. These initiatives indicate a clear understanding in all four FSM states of the need to determine and title land.

33. The agencies involved in land administration and management are faced with a broad range of demanding tasks. State land administration agencies lack up-to-date equipment across all areas of activity and need skill and technical training. The FSM state land administration agencies do not have the resource base to catch up on the backlog of work in each state; keep up with the everyday requirements for surveying, mapping, and land transfer functions; or provide for a secure and accessible land record-keeping system. In Chuuk, Kosrae, and Yap, the land administration offices are environmentally unsafe or insecure for computer modernization to assist with record processing and storage, and the present facilities for record archiving are unsound. A land use plan exists in Pohnpei, which is necessary for public health, safety, and environmental protection, but is excessively restrictive and complex, limiting usability and having a negative impact on private sector development. None of the states currently have any valuation methodology or skills to support the determination of fair market assessment of transaction prices for land rights. Markets that do exist are nonconventional and imperfect as a high measure of judgment is exercised hindering the transfer processes from both owner and buyer perspectives.

### **3. Limited Access of Small Businesses to Finance**

34. A high level of liquidity exists in the FSM banking system, mostly invested offshore. The loan to deposit ratio was 34 percent in FY1990, rose to a high of 51 percent in FY1994, and fell to 43 percent in FY1999. This does not reflect a lack of support for the domestic economy by the banks, but is indicative of other impediments to increased lending. The commercial banks

are reluctant to increase lending to the private sector because of the risky nature of start-up and small business lending, absence of effective legal provisions for securing loans against suitable collateral, as well as difficulties in foreclosure procedures. This is exacerbated by (i) commercial bank perceptions that applicants lack business experience and commercial know-how, (ii) the lack of bankable propositions, and (iii) to varying degrees, the capacity of banks to effectively support lending in the productive sectors. Even if they were prepared to lend, foreign and domestic commercial banks are reluctant to provide commercial loans below \$10,000 due to high administration costs and are mostly limited to short-term working capital loans for established and reliable businesses. The preferred bank for commercial lending is the FSMDB due to lower interest rates (9 percent) and longer repayment terms, but slow response to loan applications and perceived poor service limits access to the bank's loan capital. A survey conducted under TA 3278 (footnote 1) revealed that only 40 percent of businesses have approached a financing institution for a loan.<sup>15</sup>

35. FSMDB has made a greater contribution to the demand for start-up and expanding business capital than other commercial banks. FSMDB already has four state branches and sufficient staff, including those for outreach services to outer islands. Unlike other Pacific island development banks, its financial position is strong with relatively low debt (2.75 percent of bank-owned assets), and a high level of cash and investments (50 percent of bank-owned assets). Significant revenues are earned on investment income and in FY1999 the FSMDB recorded net earnings of \$421,444 after provision for bad and doubtful debts (\$650,000). It is seeking to improve access for small borrowers in several ways. First, loan approval authority for loans of less than \$50,000 has been decentralized to the branches. Second, under the newly launched Outreach Program, branch staff are traveling to the rural areas and outer islands to hold community meetings. Outputs under the program are reflected in the bank's annual management by objectives document, which sets objectives for outer island loans as well as small loans generally. Third, equity or margin requirements have been waived for agricultural, fisheries, and manufacturing loans of less than \$10,000 and application procedures simplified. Fourth, Kosrae and Chuuk branches have reduced minimum loan size to \$500, the former in connection with an agricultural loan scheme in which 180 loans have been made to participants of a special training course organized by Kosrae MEDC in collaboration with the extension departments. By May 2000, the Chuuk branch had already approved 20 small loans (of below \$1,000) against its target of 50 for 2000 and is processing the remaining 30. Seven of the 20 loans were provided to the trainees of the Chuuk MEDC, and 13 to women. The Chuuk branch also made 7 of the 20 loans under a separate management by objectives target to outer islanders. Partly as a result of the new FSMDB emphasis on reaching small borrowers, average loan size in 2000 until May was much lower (\$17,241) than the cumulative average of \$76,000 since the commencement of lending in 1982. Less than 2 percent of the bank's lending has been in loans of less than \$10,000. This share is expected to increase.

36. But, despite recent improvements in FSMDB's financial position and its recent initiatives to increase support to start-up and small business, the bank needs to be more responsive to local state requirements and more effective in providing banking services. A number of weaknesses must be addressed to improve FSMDB services, including an unclear corporate mission, past political interference, and operational problems. If FSMDB is to play a pivotal role in private sector development, then improvements are needed in management from the board

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<sup>15</sup> Approximately 70 percent of the financing in starting the business comes from the owners' cash contribution (40 percent) and personal assets (30 percent). Bank financing constitutes only 23 percent of start-up capital. Working capital is predominantly self-financed.

level to senior and midlevel management, through to service staff, especially in the outreach program to start-up and small business.

#### **4. Inadequate Business Support Services for SMEs**

37. SMEs in the FSM suffer from a number of problems including a general lack of entrepreneurial tradition; lack of understanding of domestic markets; inadequate sources of information on products and technologies; nonavailability or high cost of tools and equipment; lack of supplies and high cost of raw materials and intermediate inputs, most of which must be imported; and high cost of fuel, transport, and communications. The development of exports is even more difficult given the lack of exposure and experience in export markets. With the exception of local ocean fishery operators, most SMEs can be described as nonexporters, start-ups, or occasional exporters.

38. The MEDC project (footnote 10) has developed a useful program of training for entrepreneurship and business proposal preparation, and to a lesser extent, advisory services for start-up and small businesses. In particular, MEDCs have been promoting tripartite operations to help small business involved with the FSMDB small loan program; MEDCs also work with nongovernment organizations (NGOs) to promote the participation of women. All state MEDCs are located in the state department of commerce and industry except in Pohnpei where the MEDC operates as an attached unit to the Department of Resource Management and Development. Under a weak governance environment, the current status of the MEDC raises concerns of potential clients over protection of business secrets. Typically, a director or administrator; one to two local business advisers; one to two expatriate business advisers, usually international volunteers; plus an administrative assistant/secretary comprise the MEDC staff. Its limited staff base and provision of general business and entrepreneurship development cannot satisfy the demand for postbusiness start-up counseling and extension type-support. As businesses develop, the range and demand for services is expanding, including more specific market and product information, advice on joint ventures and other more sophisticated business arrangements raised in the TA business survey (footnote 1).<sup>16</sup> Increased MEDC staff capacity is urgently needed to meet the expanding demands of the nascent and diverse private sector. In particular, additional specialist staff in state business support centers and improved interagency linkages are necessary to meet more specific support needs for business.

#### **D. Government Expenditure**

39. Government expenditures for the private sector have focused on directly participating in commercial activities through public sector enterprises and their own agencies, rather than maintaining sound policy and legal systems and securing essential public services and physical infrastructure to support private sector development. Since 1987 the national and state governments have invested approximately \$300 million in public enterprises. Audit reports in 1998 indicate that the Government provided \$6.6 million in operating subsidies, other grants and subsidies, and new capital contributions.<sup>17</sup> The government expenditures for private sector support services focus on salaries, while expenditures for nonwage operational costs and new investments are limited.

<sup>16</sup> Eighty-five percent of respondents considered they needed training by order of preference in business skills (such as in marketing, customer service, etc.), entrepreneurship and management, accounting/bookkeeping, and technical skills. More than 80 percent of the respondents considered a need for on-business advisory services, primarily in solving business problems and preparing business plans. Other advisory needs are in obtaining business information and preparing loan proposals.

<sup>17</sup> Operating losses in the same period were \$12.5 million.

40. **Land Administration.** The land survey and registration agencies, land commissions, and land courts are funded through state budgets. In FY2000, the agencies combined were allocated a total of \$0.94 million, of which 90.6 percent was for salaries and 9.4 percent was for nonpersonnel recurrent costs. This level of expenditure covers two to three adjudication and survey teams per state and agency support staff, but is insufficient for the high nonsalary recurrent costs of fieldwork, especially in the dispersed outer islands of Chuuk, Pohnpei, and Yap.

41. **Development Banking.** The FSM Congress appropriated \$1.5 million in 1998 and \$1.0 million in 1999 for capital increases of the FSM Development Bank (FSMDB) bringing total equity up to \$29.5 million. FSMDB also administers, in a trustee capacity, three separate funds with combined assets of \$16.1 million at the end of 1999. The most important of these is the Investment Development Fund which aims to promote large-scale local economic development projects through joint FSM-US investment partnership arrangements. The FSMDB's budget demonstrates that it can potentially increase its lending portfolio over 3 to 4 years by \$10 million to over \$30 million, without any further injection of capital funds. With FSMDB's large investment reserves, no additional equity funds are currently needed.

42. **Business Development Support.** The UNDP/United Nations Industrial Development Organization (UNIDO)-supported Micronesian Entrepreneur Development Center (MEDC) project started in 1993 in Pohnpei. Since the start of the MEDC Phase II program in 1996, the national Government, through appropriations obtained from the FSM Congress, has directly contributed to the budget of the MEDC program. The total contribution of the FSM Government was \$0.55 million during the last five fiscal years (1996/2000). In addition, state governments provide in-kind and budgetary contributions for center operations including office facilities, staff salaries, and other operation and maintenance costs.

## **E. Government Objectives and Strategy**

43. The change in government policy from public sector-led growth to private sector-led growth, initiated through the PSRP, represents a fundamental shift in strategy for the FSM. Policy initiatives under way include restraining government employment and wages, reforming public enterprises, promoting foreign investment, liberalizing banking regulations, improving leaseholds, and improving business support. However, the Government is also realizing the complexities of these initiatives and what is involved in the shift from government-led development to a private sector-led approach. Hurdles include the process of developing public understanding; refining policies and strategies; gaining acceptance; passing laws; and most importantly, effectively implementing agreed programs. The Second FSM Economic Summit provided an opportunity to discuss and develop specific policies, strategies, and activities to support private sector development. The results are detailed in the private sector development policy matrix, which comprises five key elements.

44. The first element focuses on commitment to economic reforms by maintaining financial stability. Implementation strategies include maintaining balanced budgets and a low level of external debt by avoiding net increase in public service employment levels; developing and enforcing effective conflict of interest laws; balancing tax increases with corresponding government expenditure reductions, and elimination of inefficiencies and misallocations; removing distortions of the current tax regimes; and establishing medium-term revenue neutrality (no increase in tax burden).

45. The second policy element aims to develop an outward looking approach to economic development by developing a tax regime consistent with outward-oriented economic strategy, and eliminating distortions arising from the current tax system; and encouraging investment in priority and potentially competitive export growth industries. Strategies include creating an attractive environment for investors by developing transparent laws and regulations supportive of investors; and promoting investment in priority industries, especially exports.

46. The third policy element emphasizes lowering costs, improving performance, and developing competitive markets for resources. Policies and strategies for land, labor, and capital include the following:

- (i) **Labor policies.** Ensure labor is wage competitive by reducing public-private sector wage differentials, increase labor productivity and competitiveness, and direct human resource development investment to skill gaps for priority growth industries.
- (ii) **Land policies.** Make land more readily available to those who need it for development, facilitate the use of land as collateral to increase availability of development financing, regulate land use to promote desirable and more efficient industry clusters, and avoid incompatible and unsustainable uses.
- (iii) **Finance policies.** Reduce the risks of bank lending and borrowing for domestic business and exports, reduce disincentives arising from the risks of business losses for unrecoverable debt, broaden the quality and scope of bank financial services and products, and build responsiveness to the working and investment capital needs for business development in priority industries.

47. The fourth policy element emphasizes reorienting public agencies and administration to facilitate private sector development, decreasing the cost and increasing the ease of doing business, promoting good governance, and minimizing government involvement in commercial and service activity. Two main areas are covered:

- (i) **Regulatory environment.** Develop a corporate and business enabling and regulatory environment that promotes a private sector capable of generating long-term economic value and respects the interests of stakeholders and society.
- (ii) **Commercialization and business development support.** Support competitive tradable goods and services; focus on efficient, coordinating, support services providing information, advice, and training, not subsidized finance; support business development at all levels experience and growth; and allow the market to determine the value and commercial viability of state-owned, production-type enterprises earmarked for privatization.

48. The fifth policy element comprises providing efficient and cost-effective infrastructure to support competitive private sector development by removing infrastructure-related production constraints through feasible public investments, adequate operation and maintenance, and ensuring coordination in the provision of social service infrastructure to support economic and private sector development.

49. The impetus for the private sector development policies emerged from the Government's recognition that proactive steps are needed to promote private sector-led growth, especially in

view of the sector's slow response to public sector downsizing. The participants of the Second FSM Economic Summit noted that while much progress had been made since the First Summit in 1995, more active, coherent policy monitoring and implementation is definitely needed throughout the FSM. Therefore, the membership of the State-National Leadership Conferences was formalized as the FSM Economic Policy Implementation Council (EPIC). With a goal of improving economic policy monitoring and implementation support, EPIC will comprise executive and legislative leaders from the national and state governments. DEA acts as the EPIC secretariat. Policy-focused meetings will be convened at least every May and October in conjunction with regular session of the FSM Congress. The PSDP and its implementation should integrate with these newly instituted mechanisms and structures.

## **F. External Assistance to the Sector**

50. The US Compact assistance is a major influence in the FSM economy. The assistance provided through the Compact includes a block grant of which no less than 40 percent must be allocated to capital improvement projects. In addition, goods with a domestic value added of 30 percent or more are eligible for duty-free access to the US with the exception of canned tuna and certain products for the garment industry. In addition, the FSM receives no-cost assistance for weather services, emergency management, and aviation administration from US agencies. The US Congress also agreed to provide the FSM with access to services and programs of the Federal Deposit Insurance Corporation, Small Business Administration, Economic Development Administration, and Job Partnership Training Act, among others. The US Department of Interior, through additional federal grant programs available to the FSM, has also provided assistance to the Pohnpei Division of Lands to automate the surveying and mapping functions to speed up the processes of cadastral surveying and mapping. The US Peace Corps provides volunteers to a wide range of sectors, including education, agriculture, and commerce and industry.

51. Japan provides an assistance package each year to the four FSM states and the national Government on a rotating basis, usually for infrastructure and fisheries projects. A small grant fund is also administered by the Japanese Embassy that targets community self-help activities and other small-scale development projects. Since 1995, the embassy has awarded approximately \$10 million to small projects. A Japan International Cooperation Agency TA commenced in August 2000 to restart the former Micronesia Maritime Academy in Yap in cooperation with the College of Micronesia-FSM. Each year, approximately 20 Micronesians from the government and private sector are funded for Japan-based training in social, economic, and business-related areas.

52. UNDP has had an active program in the FSM since its independence. In the past, the program included extensive support to agriculture (pepper, poultry, veterinary services, and crop protection). This type of assistance to specific enterprises has been curtailed due to lack of funding. The UNDP/UNIDO assistance to the SME sector has expanded successfully from a project piloted in Pohnpei State executed by UNIDO to the establishment of the MEDCs.

53. Australia provides assistance in the area of land administration for developing geographic information systems in Kosrae and Pohnpei. The Australian Government has provided a small grant to the Pohnpei MEDC to conduct training in business extension services to rural entrepreneurs. Experienced senior volunteers have offered a variety of training related to business and business management to public agencies and the private sector.

54. The World Bank provides assistance to the FSM through its regional programs. The Foreign Investment Advisory Service, cofinanced by the World Bank and ADB, has been

providing advisory services throughout the review and revision process for the FSM's foreign investment laws and regulations. Direct assistance is being provided through the South Pacific Project Facility to the FSM's private sector fisheries businesses. ADB TA has assisted a Pohnpei-based longliner company in operations management and the Pohnpei Longline Fisheries Association in assessing alternative air freight arrangements.

55. The Pacific Islands Small Business Development Centers Network, based in Guam, provides assistance and an annual grant of \$30,000 to the Yap SBDC. The Pacific Business Center of the University of Hawaii continues to provide advisory services to the government and businesses in the states of Chuuk and Yap. Even though the connections and networks from the two programs have proven valuable, their visits are limited to four times a year for about two weeks per visit.

## **G. ADB's Operations and Strategy in the Sector**

### **1. Strategy**

56. ADB's country operational strategy reflects the Government's own development strategy aimed at implementing the economic reforms presented to the Fourth Consultative Group Meeting. ADB's current strategy focuses on public sector rationalization and private sector development through key reforms to land, labor, and capital market institutions. This strategy was confirmed by the national and state governments as well as by the private sector and NGOs. Given the federal government structure in the FSM, ADB operations give increased attention to individual states' development needs and is strongly linked with their performance and commitment to reform.

### **2. Operations**

57. ADB loans have been approved for the PSRP, a water supply and sanitation project, and a fisheries development project. While the overall objective of the PSRP was to achieve sustainable economic growth through private sector development, the focus during program implementation was placed on the fiscal adjustment and downsizing of governments rather than the medium- to long-term goal of establishing an enabling environment for private sector development. The ADB project for fisheries development experienced mixed performance due to the lack of a favorable sector policy and governance environment.

58. ADB TAs have focused on good governance and capacity building. To improve the governance and institutional capacity for private sector development, a TA was provided in the areas of economic policy formulation, performance-based budgeting, public sector enterprise reform, land management, financial sector review, and fisheries management.<sup>18</sup>

59. Lessons learned from ADB operations in the sector include (i) ADB's projects need to be consistent with individual state needs and performance, including their commitment to reform; (ii) to create a policy and legal environment that is more business friendly, reforms should

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<sup>18</sup> TA 2786: *Investment Promotion and Financial Sector Review*, for \$380,000, approved on 8 April 1997; TA 2832: *Fisheries Management and Development*, for \$934,000, approved on 2 July 1997; TA 2983: *Performance-Based Public Resource Allocation*, for \$988,000, approved on 26 January 1998; TA 3024: *Economic Policy Reform and Management*, for \$2,877,000, approved on 12 May 1998; TA 3201: *Privatization of Public Enterprises and Corporate Governance*, for \$450,000, approved on 9 June 1999; and TA 3258: *Strengthening the National Statistical System*, for \$400,000, approved on 21 September 1999.

precede ADB's investments in revenue-generating sectors; and (iii) weak local capacity should be taken into consideration in preparing projects.

### **3. Policy Dialogue**

60. ADB is assisting the Government to develop and implement its continued economic reforms aimed at private sector-led growth. As a result of continued policy dialogue with ADB, the national Government has identified private sector development as the primary development goal and developed future policy actions and implementation mechanisms through the Second FSM Economic Summit in 1999. Subsequently, the PSDP (2000) and TA 3278 (footnote 1) were reflected in the ADB country assistance program 2000/02. To avoid risk of duplication and maximize ADB resources available for the FSM, ADB coordinated its ongoing TAs whose outputs have strong links with those of the TA for the PSDP. These include TAs for economic policy management, improved use of land, public enterprise reform and corporate governance, financial sector review, and national statistics strengthening. UNDP also participated in the Government's formulation of PSDP through the involvement of MEDC staff and consultants.

61. During TA 3278 implementation, the fourth Consultative Group Meeting was held at ADB headquarters in February 2000. The FSM Government demonstrated its willingness to stay the course of reforms and to adopt a concrete policy framework to implement the reforms. ADB and other development partners commended the Government's development strategy for achieving a self-reliant economy through private sector development.

## **IV. THE SECTOR DEVELOPMENT PROGRAM**

### **A. Rationale**

62. The FSM's major challenge is to accelerate private sector development as the main engine of growth, particularly in the productive sectors (fisheries, agriculture, and tourism), which are to provide alternative sources of foreign exchange to reduce the country's dependence on external assistance as well as generate employment for the rapidly growing population. The proposed PSDP is to assist the Government in implementing its economic development strategy for private sector-led economic growth. Preparation of the Program involved a high level of public discussion and participation.

63. The PSDP will seek to induce an increase in the production of tradable goods for domestic and export markets, as well as a competitive nontradable service sector. Improvements in access to and the use of land for economic activity is required, including accelerated titling and registration, extended lease terms, and the ability to use land and other property as collateral to access finance for business development. Access to capital and finance for business development can be enhanced by improving the enabling legal framework and financial services for start-up and expansion of SMEs. A price-competitive labor force is required with the skills needed by the private sector. Finally, while the choice of business activity is entirely a matter for the private sector, advisory support is needed for informal and formal SMEs to develop private sector distribution channels, assist with product diversification and provision of market information, change product positioning to fit consumer demand, improve the stability and reliability of supply, improve communication, develop price competitiveness, and assist in focusing on core competencies through a better matching of internal and external factors.



## **B. Objectives and Scope**

64. The goal of the PSDP is to promote economic growth by expanding the FSM private sector, thereby raising domestic employment and incomes, and reducing dependence on external assistance. To attain this goal, the PSDP's objectives are to (i) improve the policy and legal environment for private sector development; and (ii) strengthen capacity to manage land, labor, and capital resources.

65. The PSDP's scope is national and statewide. The PSDP includes (i) a policy framework and actions and (ii) an investment project aimed at improving performance of the public services to promote private sector development. The investment project comprises (i) establishing a secured transaction system; (ii) providing institutional capacity building for land administration and management, financial support to SMEs, and business development support; and (iii) strengthening the capacity for coordinating and monitoring the PSDP. The investment project description is attached as Supplementary Appendix A.

## **C. Policy Framework and Actions**

66. The PSDP is built on consensus generated at the Second Economic Summit and local commitment to the overall reform effort. A policy matrix was developed by translating the policy framework for private sector development endorsed at the Summit. To maximize the impact of the reforms, policy actions and the time frame in the policy matrix reflects key factors including (i) differences in each state's financial and legal situation, (ii) local acceptance of reforms including land-related reforms, (iii) local implementation capacity, and (iv) availability of current and future external resources to support the reform measures. Quantifiable and monitorable targets have been identified and are integrated into the program framework in Appendix 1. The development policy letter and policy matrix are in appendixes 2 and 3.

### **1. Maintain Economic and Public Sector Reforms**

#### **a. Maintenance of Balanced Budgets**

67. In general, the expansionist fiscal policies in the FSM national and state governments prior to FY1996 led to a more difficult and painful adjustment process following the second step-down in Compact funding. However, in facing up to the necessary adjustments to declining transfers, the response has been positive, with small budget surpluses in FY1998 and FY1999. Recent efforts and successes in improving fiscal management and discipline must be maintained, and where possible, extended to avoid previous public financial crises that affected the delivery of essential public services and private sector growth. Over time, faster private sector growth should be encouraged, and the ratio of government expenditure to GDP allowed to fall to less than 50 percent of GDP. Fiscal discipline and financial stability are required to improve business and investor confidence in the FSM economy. The governments are therefore committed to maintaining balanced budgets for FY2002/04 on total current revenues and grants less current expenditures.

#### **b. Maintenance of Government Payroll Levels and Reduction of Public to Private Sector Wage Differentials**

68. An important component of the PSRP was reducing government size and operating costs. However, the emphasis has changed. In certain states, the reductions are continuing with the intention of restructuring the civil service to be smaller, but staffed with better-qualified

personnel. The reduction of government employment is an important step in reducing labor market competition between government and the private sector, and increasing the availability of skilled and qualified labor. Limiting the size of government by avoiding a net increase in public service payrolls will ensure that the size of the civil service does not become an unsustainable financial burden or a source of competition for labor with the private sector. Pay restraints are important to remove pay differentials; the public to private sector ratio is currently 1:8. Payroll ceilings consistent with medium-term fiscal balance for FY2002 will be set at a level that does not exceed the PSRP FY1999 target for the ratio of wages to total expenditures for each national and state government. In FY2003 and FY2004 these ceilings will be maintained with small upward adjustments.

#### **c. Sound Management of the FSM Trust Fund**

69. In 1999, the FSM began negotiations with the US for a new package of assistance once the current package expires in 2001. In essence, future Compact payments are expected to cover not only agreed areas of assistance, but also regular payments into the FSM Trust Fund to ensure a self-sustaining stream of revenue for government operations after a possible second Compact agreement expires. A law for establishing the FSM Trust Fund was enacted, and the national Government has appropriated \$4 million to date. A prudent measure is to increase the commitment to the future financial stability of the FSM by increasing savings and investment in the FSM Trust Fund. If the current Compact agreement is extended for two years, at least half of the 27.5 percent increase of budgetary support under the Compact base grant for FY2002 and FY2003 will be placed into the FSM Trust Fund. This would avoid a short-term reexpansion of public spending and contribute to the FSM's future financial independence.

#### **d. Sound Management of External Debt**

70. Prior to FY1990, the FSM had no official public debt to offshore lenders. Between FY1990 and FY1993, total official external debt increased to a peak of \$137 million in FY1993 representing 66 percent of GDP. Since FY1993, the only official debt has been through ADB's concessional lending facility. While the situation was adverse in the early 1990s, it will be sustainable by 2002 following completion of payment of a medium-term note program. By FY2001, the debt to GDP ratio is expected to be 24 percent. While this situation appears to be relatively good, the uncertainties over Compact renegotiations and future debt service capacity are still cause for caution and for avoiding resurgence of unsustainable external debt. The current policy is to maintain a low and sustainable level of net external debt. Accordingly, the Government has committed that the debt-to-GDP ratio will not exceed 24 percent in FY2002; this ratio will be maintained during FY2003 and FY2004.

#### **e. Progress in Public Sector Enterprise Reforms**

71. Vigorous implementation of public sector enterprise (PSE) reforms is required to reduce the government budgetary burden of nonperforming PSEs and eliminate public sector competition with the private sector. The three-year phased ADB TA (footnote 13) of which the first phase was implemented in 2000, facilitated the development of a framework for and implementation of PSE reforms. The Public Enterprise Unit was established in DEA in 2000 to manage the process. To fulfill the policy of reducing losses, increasing private sector opportunities, and eliminating public sector competition with the private sector, the five governments will identify priority enterprises to be privatized and set specific national and state targets. Preliminary candidate public enterprises for privatization were identified in September 2000 through a participatory process with government and other stakeholders. Following this,

draft master plans for PSE reforms were completed during this year. At least one PSE reform by each national and state government will be implemented by August 2003.

## **2. Improve the Legal Environment for Private Sector Development**

### **a. Pass Laws to Improve Use of Land and Property as Loan Security**

72. The FSM is addressing a number of issues in the legal and regulatory environment by extending minimum lease terms and improving access to finance through leasehold mortgage lending. The long-term, land-lease system will make land more readily available without having to amend constitutions. Effective security mechanisms using leasehold mortgages will help avoid many of the freehold mortgage problems by making foreclosure a less daunting prospect. An ADB TA for improved use of land has proposed model state legislation and forms for developing a system of long-term land leasing and leasehold mortgaging. Wide public awareness campaigns on modernizing the land market were completed in 2000 by a local NGO under the TA. The legal reforms to enable the improved use of land (footnote 14) and property as loan security include (i) amendment of state land-lease laws, and (ii) passage of state mortgage laws. Long-term, land-lease legislation will be drafted by November 2001 and enacted by August 2003. At the end of the program, a secured transaction system will be established under the investment Project to enable banks to increase mortgage-secured commercial lending.

### **b. Improve Foreign Direct Investment Laws and Regulations**

73. In May 2000, the governments reviewed the current foreign direct investment laws with the assistance of experts funded by the Foreign Investment Advisory Service and ADB. Specific recommendations have been made for new foreign direct investment systems with improved transparency and consistency in the national and state governments. A core objective is to simplify the application procedures and reduce discretionary reviews and approvals. Revised and improved foreign investment laws and regulations will be put into effect by August 2003.

## **3. Adjustment Costs of the Reforms**

74. Public enterprise reform will result in several costs, including possible redundancy payments; loss of earnings to displaced workers during the transition to the private sector; and other restructuring, divestiture, and liquidation expenses. In FY1998, public enterprise wages were \$10.3 million. The workforce reduction under the proposed PSE reforms was estimated at 10 percent of the total PSE workforce. A redundancy payment of two years for released workers, which was applied to early retirees under the PSRP, will require about \$1.5 million in 2003. Retraining costs through the existing vocational training programs are estimated at \$2.0 million. Administrative and legal expenses for PSE reform are estimated at \$1.5 million. These costs will be partly offset by reducing subsidies to loss-making enterprises.

75. The proposed policy loan will help finance the total adjustment costs estimated at \$5.0 million, while maintaining fiscal discipline by keeping Government expenditures in line with revenues. The costs of improving the institutional infrastructure for private sector development will be met through the investment Project.

## **D. The Investment Project**

76. Strengthening the institutional infrastructure of the national and state agencies is required to improve the environment for private sector development. The investment Project comprises three components: component A, establishment of a secured transactions system; component B, strengthening of institutional capacity to support PSD including state land administration, FSMDB, and state MECs; and component C, program and project management.

### **1. Establishment of a Secured Transactions System**

77. The first component is to establish a secured transaction system through secured transactions laws and chattel mortgage registries in the national and state governments. The existing state and national government secured transaction laws will be reviewed. To resolve a jurisdictional problem between the national and state governments in this area, a comprehensive national secured transaction law is proposed that will override state laws; however, a state can still have its own secured transaction law. Once a mortgage is filed in a state under a state law, it can also qualify under national law. Under the proposed bill at the national Congress, a single nationwide system will be set up with offices in each state where filings can be made and searches obtained. The computerized chattel mortgage registry will be established within state land administration and the registrar's office in Palikir. A significant number of additional staff are not required within the registries; however, hardware will be supplied and installed, software provided, and training given to establish a central electronic data bank for secured transactions filings, with real-time links to each of the state field offices. This will take the form of a web site in which concerned persons including bankers, and attorneys, and the field offices can search for filings against a certain debtor.

### **2. Strengthening of Institutional Capacity to Support Private Sector Development**

78. The second component aims to strengthen the institutional capacity of the national and state agencies providing essential services to support private business development.

#### **a. Land Administration and Management**

79. This subcomponent aims to (i) promote the modernization and development of the land registration and cadastral systems; (ii) expedite the issuance of land titles by improving procedures for adjudication, survey, and registration; (iii) support state initiatives to develop an appropriate judicial framework related to land dispute resolution; (iv) support appropriate systems for zoning and land use planning; and, (v) develop land valuation methodologies and train officials from each of the states in the valuation methodology.

80. The investment will provide for three inputs. (i) Civil works: the construction of new, purpose-built offices for the land agencies in Chuuk, Kosrae, and Yap to provide secure temperature and humidity-controlled vaults for records, temperature-controlled computing rooms, and a secure public access area. In Pohnpei, the existing building housing the Land Tenure Court will be renovated to provide a secure, temperature and humidity controlled vault for records and to rewire the building. (ii) Equipment: modern survey equipment will be provided to automate the survey and mapping functions (global positioning system receivers, total station theodolites, and computer hardware and software); Pohnpei's experience with US dollar funding shows that productivity can be at least doubled, while other countries have found that significant cost reductions can be achieved and new and simplified practices and methods introduced to

reduce cost per land parcel survey from \$550 per parcel to \$30 per parcel). The new technology combined with the implementation of new practices and methods will achieve corresponding reductions in time. New technology (computer hardware and software) will also be introduced to automate the registration activities to speed up the issuance of titles and reduce the possibility for fraud and corruption. The automated survey and registration systems will be integrated to produce time and cost savings. (iii) Consulting services and training: these will be provided to strengthen the institutional, administrative aspects of the land-titling process, including in particular, in Chuuk and Yap, new and simplified adjudication (land dispute settlement procedures). The survey and mapping consulting will include a course in survey and mapping to create a cadre of licensed surveyors to enable the ultimate privatization of these functions, with particular emphasis on the privatization of the survey and mapping functions in Pohnpei State during project implementation; legal consulting services will be provided to amend existing legislation, as appropriate. All states will benefit from the proposed valuation consulting, which will develop a valuation methodology and train state representatives in valuation to ensure an equitable and transparent valuation service. Finally, this subcomponent will help Pohnpei implement a simplified land use master plan and implement a geographic information system to monitor its implementation.

#### **b. Financial Services to SMEs**

81. While commercial bank lending will be encouraged by developing enabling mortgage legislation, development banking services for SMEs will be improved through an integrated program of technical and in-service training assistance for FSMDB. This program will commence with a program of training and support to FSMDB's board on governance issues, roles, and duties. Under a new corporate plan,<sup>19</sup> FSMDB will focus on business promotion, customer service, financial sustainability, and development of human resources. FSMDB will develop the existing management by objectives system with each state branch setting lending, collection, and profit objectives. FSMDB will increase branch-level authority in response to increased capacity and to overcome the past constraints of centralized decision making. Specific attention will be given to developing FSMDB's new outreach program, which will be especially important for delivering effective financial services to start-ups and small business. A skills audit will assess the training needs of individuals relative to their job descriptions and a comprehensive training program will be developed. A long-term integrated program for capacity building, including the full-time attachment of a senior development banking adviser, and training and advice by short-term experts in the fields of information and computer systems and human resource development will be provided.

#### **c. Small Business Development Services**

82. The MEDCs will be strengthened to provide a comprehensive small business support service, improved delivery of skills training, and a labor market information system. The strengthened MEDCs will be renamed small business development centers (SBDCs) and will also expand their outreach business extension services to the informal sector, outer islands, women and youth, and targeted priority sectors. This will require the delivery of business training and advisory services that closely consider factors such as the current level of commercialization, business development, and educational attainment of beneficiaries. The larger states of Chuuk and Pohnpei will require more business trainers and advisers, some of which may be on a part-time or request basis. Information technology will be enhanced through

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<sup>19</sup> The Economic and Social Commission for Asia and the Pacific provided assistance for the preparation of a revised corporate plan in 2000.

an Internet-based business and technical information service that will link the four state SBDCs to DEA and appropriate information worldwide. This information system is expected to be simple but consistent with the needs of businesses in the FSM. Information on labor demand and supply will be included so that those seeking workers and those seeking employment will be served by the information system. Consulting services will be provided for training business center staff, developing the labor market information system, establishing the required procedures, and updating the necessary training materials. Supported by the new business and labor market information system, the business adviser in each SBDC will identify new training needs and provide advisory support for established and emerging businesses. New buildings for the SBDCs in Chuuk, Kosrae, and Pohnpei will be constructed within the state campuses of the College of Micronesia (COM)-FSM. In each of these states, the facilities to be constructed will be joint-use buildings, which will also accommodate the vocational training programs of COM. The training and counseling facilities of the Yap Business Center will be upgraded. The center currently operates as an incubator system.

83. To ensure access to the best possible advice and secure the input of the private sector, the SBDC will be advised in each state by a business development council (BDC), which will have representatives from the private sector, banks, COM, NGOs, and the state government, and will replace the current MEDC board. The SBDC's legal status will be converted to a state nonprofit corporation to improve transparency and performance of its business support services. The BDCs will be managed by state COM campuses (except in Yap). The national Government's current budget support will be maintained through the COM-FSM budget to the state campuses, except in Yap where it will be channeled through the state government. This new structure and other modifications have been included in the proposed business development act for the states. Linkages between the SBDCs and FSMDB will be enhanced to ensure that the outreach services of the two institutions, including staff capabilities, are compatible and consistent. Annually, the BDC will review the delivery of SBDC services and development of private sector services to ensure that the centers are not providing competing services or undermining the development of private sector business support services. In this regard, the SBDCs will be encouraged to provide training-of-trainers to existing nongovernment business organizations, and introduce and increase user fees as appropriate.

### **3. Program and Project Management (Component C)**

84. A program-project implementation unit (PIU) will be established within DEA. Despite the fact that DEA has served as the implementing agency for various ADB project and program loans, its capacity for effective policy implementation and coordination requires strengthening. This is considered necessary, as part of the restructuring and rebuilding of DEA's capacity for implementation and service support to the FSM states under the ongoing public sector reform efforts. Equivalent procedures and capacity building will be needed at the state level. A project organization chart is attached as Appendix 4.

85. For the first three years, an internationally recruited program-project manager (PPM) will be responsible for the day-to-day implementation of the PSDP. A counterpart manager will be trained to take over in year four. The involvement of the expatriate PPM (total duration of 24 person-months) will be gradually phased out over the three years. The PPM will be expected to (i) design disbursement, procurement, and recruitment procedures and guidelines under the PSDP; (ii) develop monitoring and evaluation systems; (iii) facilitate the national and state steering committees in four states; (iv) help DEA and the steering committees publicize the improvements and changes under the PSDP, and (v) train PIU counterpart staff and the state counterpart staff from each agency assigned to manage program and project implementation.

The PIU will interact with the state governors' offices, which will coordinate the program and project activities and investments at the state level.

#### **4. Fees for Services**

86. No land office currently charges for land survey services; although citizens have indicated their willingness to pay to expedite the survey. Under the Project, the fee for service concept for activities carried out by the land administration agencies will be introduced. These activities include issuance of land titles, land transactions, and information requests associated with leasing and mortgaging. The immediate goal of the fees will not be full cost recovery, but rather, establishing the fee for service principle. Nominal charges will be introduced during the course of component implementation for certain activities associated with first registration activities, e.g., expedited registration, while full charges will be levied for secondary transactions in land rights, such as leases and the recording and registering of mortgages. Such subsidies are justified as part of the modernization process. Nonetheless as the improved land administration systems become established, fee structures for land titling will be reviewed with a view to increasing cost recovery for the systems.

87. The newly established SBDC will apply fee for service to training and advisory services. As with the land administration services, the immediate goal of the fees will not be full cost recovery, but rather establishing the fee for service principle. In addition to direct appropriations from government, various other grant sources from external financiers may be explored to finance the operation and investment requirements of the SBDCs.

#### **5. Cost Estimates**

88. The total cost of the investment Project is estimated at \$13.032 million equivalent, including physical and price contingencies, taxes and duties, and interest charges during construction. Of the total costs, \$6.699 million (51 percent) is the foreign exchange cost, and \$6.333 million equivalent (49 percent) the local currency cost. A summary of cost estimates is shown in Table 1, and the detailed breakdown is given in Appendix 5.

**Table 1: Cost Estimates**  
(\$ '000)

<b>Project Components</b>	<b>Foreign Exchange</b>	<b>Local Currency</b>	<b>Total Cost</b>	<b>Percent</b>
<b>A. Base Costs</b>				
1. Secured Transactions System	111	184	295	2.27%
2. Institutional Capacity Building	5,405	5,203	10,608	81.40%
3. Project Implementation Support	456	370	826	6.34%
<b>Subtotal (A)<sup>1</sup></b>	<b>5,973</b>	<b>5,757</b>	<b>11,730</b>	<b>90.01%</b>
<b>B. Contingency</b>				
1. Physical <sup>2</sup>	418	403	821	6.30%
2. Price <sup>3</sup>	179	173	352	2.70%
<b>Subtotal (B)</b>	<b>597</b>	<b>576</b>	<b>1,173</b>	<b>9.00%</b>
Interest Charge <sup>4</sup>	129		129	0.99%
<b>Total<sup>5</sup></b>	<b>6,699</b>	<b>6,333</b>	<b>13,032</b>	<b>100.00%</b>
<b>Percentage</b>	<b>51.41%</b>	<b>48.59%</b>	<b>100.00%</b>	

SME = small and medium enterprise.

<sup>1</sup> Estimates as of July 2001.

<sup>2</sup> Calculated at the rate of 7 percent of base costs.

<sup>3</sup> Calculated at the rate of 3 percent per annum for both foreign exchange costs and local currency costs.

<sup>4</sup> Estimated on the basis of 1 percent per annum for project loan disbursements.

<sup>5</sup> Inclusive of estimated taxes and duties. Totals may appear not to add up, due to rounding.

Source: Staff estimates.

## **E. Social and Environmental Measures**

89. The proposed policy reforms and investment Project will have significant social and, to a lesser extent, environmental impacts in the FSM. A description of these features follows.

### **1. Participatory Development and Improved Governance**

90. In the course of economic and legal reforms, the newly established national and state economic policy implementation councils (EPICs) will help to maintain the reform momentum, build consensus, and monitor implementation. The newly established BDC in each state will serve to provide feedback from the informal and small business sectors to the government and to establish partnerships with the government.

91. Amended foreign direct investment laws and newly established mortgage and bankruptcy laws will improve transparency, fairness, and predictability in business regulation and protection of creditors and debtors. Converting the current MEDC from a Government unit into an arms-length SBDC will help protect business secrets of start-up businesses and enhance the credibility of the SBDCs.

### **2. Women, Youth, and the Poor**

92. The ongoing business support program and the FSMDB small loan program show that equality in access is achievable. The specific needs of women, youth, and the poor will be



further addressed under the SBDC and FSMDB strengthening components through their small business support program and outreach program. The outreach program will target locationally disadvantaged outer islanders particularly in Chuuk and Yap. Specific output targets will be set up, aimed at women and monitored by the SBDC and FSMDB.

93. The investment Project will focus on Chuuk, where half of the FSM population resides and where the poor constitute 53 percent of the state population. Pohnpei is actively addressing the resettlement needs of squatters found in Kolonia and in the uplands of the main island. Measures include (i) provision of leasehold contracts for occupied lands that will be convertible to freehold sale contracts at the end of the lease term; and (ii) establishment of a state land-use plan that will, among other things, provide alternative land for resettlement. Acceleration of land titling under the investment Project will contribute to preventing further squatting and implementing resettlement without significant economic and social costs. Furthermore, proactive land survey and titling in outer islands where demand is strong will prevent migration to the main islands by enabling investment in housing and income-earning sectors such as fisheries, agriculture, and tourism. The construction of new buildings for state land administration offices and SBDCs will not result in significant land acquisition problems since all the identified land sites are currently owned by the state governments and COM state campuses.

### **3. Environment Interface**

94. The overall PSDP is classified in environmental category C. An environmental impact assessment matrix is attached as Appendix 6. Environmental implications were reviewed and no adverse impacts were identified, with specific project activities expected to safeguard the environment as development proceeds. The land administration and management subcomponent will improve the environmental sustainability of land use by providing capacity building in land management. Streamlining and improving the monitoring of land use laws and regulations, including geographic information systems, will assist islandwide land management. Initially this will be carried out in Pohnpei. Acceleration in land dispute settlement and titling is expected to have a positive impact on the environment with clear property rights providing a greater incentive for sustainable land parcel management over the long run.<sup>20</sup>

## **V. THE PROPOSED LOANS**

95. Implementation of the PSDP requires increased recurrent expenditures and additional investments to carry out the reforms, as well as to improve institutional infrastructure essential for enabling private sector growth. The PSDP will be funded by proposed ADB loans equivalent to \$13.017 million, including a policy-based loan (\$5 million equivalent) and an investment loan (\$8.017 million equivalent) sourced from ADB's Special Funds resources. The national and state governments will finance sector investments amounting to \$5.015 million. The financing plan for ADB assistance is given in tables 2 and 3, and details for the two loans follow. Details of financing arrangements are in Appendix 5.

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<sup>20</sup> The Nature Conservancy, an NGO with operations in Pohnpei, is actively promoting community-based watershed management, which includes the training of island communities in sustained economic use of lands owned or controlled by the communities. The watershed management program has identified the settlement of disputes and title issuance as essential for improved management.

**Table 2: Financing Plan**  
(\$ million)

<b>Loan</b>	<b>ADB</b>	<b>National</b>	<b>States</b>	<b>Total</b>
Policy Loan	5.000	0.000	0.000	5.000
Investment Loan	8.017	1.388	3.627	13.032
<b>Total</b>	<b>13.017</b>	<b>1.388</b>	<b>3.627</b>	<b>18.032</b>

Source: Staff estimates.

**Table 3: PSDP Loans/Cost Allocation Among the National  
and State Governments**  
(\$'000)

<b>Loan</b>	<b>National</b>	<b>Yap</b>	<b>Chuuk</b>	<b>Kosrae</b>	<b>Pohnpei</b>	<b>Total</b>
Investment Loan	2,779	1,204	1,780	1,261	994	8,017
Policy Loan	1,000	800	1,300	800	1,100	5,000
<b>Total PSDP Loans</b>	<b>3,779</b>	<b>2,004</b>	<b>3,080</b>	<b>2,061</b>	<b>2,094</b>	<b>13,017</b>

PSDP = private sector development program.

Source: Staff estimates.

## **A. The Policy Loan**

### **1. Amount of Loan, Terms, and Sources of Funds**

96. It is proposed that ADB provide a policy-based loan of \$5.0 million equivalent to support the Government's implementation of the policy and legal reforms for private sector development. The total amount of the loan would be provided from ADB's Special Funds resources. This loan will have a maturity of 24 years, including an 8-year grace period, 1 percent interest charge per annum during the grace period and 1.5 percent per annum thereafter, and equal amortization. The size of the loan is based on the scope and the costs of the reforms, the importance of the reforms, and the state of public finances.

### **2. Implementation Arrangements and Executing Agency**

97. The Department of Finance and Administration (DOF) will be the Executing Agency, responsible for initiating withdrawals under the loan, and for allocating and monitoring the use of counterpart funds. DEA will be the Implementing Agency. A PIU will be established within DEA to support program management. State governors' offices will be the implementing agencies at the state level. A steering committee, co-chaired by the Secretary of Finance and the Secretary of Economic Affairs, and to include the Governors of the states or their representatives and a representative for each of the COM and FSMDB, shall be established to monitor and coordinate the Program and the Project.

### **3. Procurement and Disbursement**

98. Procurement of eligible items under ADB's program loan will be based on normal commercial practices for procurement by the private sector or standard Government procurement procedures acceptable to ADB for procurement by the public sector. In the case of goods commonly traded on international commodity markets, procurement will be undertaken in accordance with procedures appropriate to the trade and acceptable to ADB. A list of ineligible

items is attached as Appendix 7. ADB ensures that standard private and public sector procurement procedures used in the FSM are adequate in terms of competition and efficiency.

99. With each withdrawal request, the Borrower will be required to submit a certification confirming compliance with the following formula: for each year in which the proceeds of the loan are expected to be disbursed, the annual withdrawal request is less than the value of the country's total imports minus (i) imports from nonmember countries, (ii) ineligible imports, and (iii) imports financed by other official development assistance. ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the Borrower's certification.

#### **4. Counterpart Funds**

100. The counterpart funds to be generated from the loan proceeds will be used by the national and state governments to support implementation of the policy and legal reforms set out in the policy matrix (Appendix 3). The Government has agreed that counterpart funds generated by the transfer of loan funds from ADB will be deposited in the special account. The account will be operated jointly by DEA and DOF, and the funds disbursed to state governments for implementing reforms for private sector development. Appropriate arrangements will be made between the national and state governments to ensure that counterpart funds allocated to the states are disbursed upon compliance with the conditions specified for each state in the policy matrix. Such counterpart funds will be transferred from the national Government to the state governments, with terms and procedures to be agreed upon by the national and state governments.

#### **5. Monitoring and Tranching**

101. The policy component will start in February 2002 and end in February 2005. The loan of \$5 million will be released in two equal tranches. The first tranche will be made available upon loan effectiveness (expected about February 2002). The second tranche is expected to be released in August 2003 subject to the fulfillment by the governments of specific conditions for its release, as detailed in the development policy letter (Appendix 2), and the accompanying policy matrix (Appendix 3), including satisfactory progress in implementing the investment Project.

102. The Government and ADB will review PSDP implementation on a continuing basis, a joint review conducted during the third quarter of 2003 prior to the release of the second tranche. To assist in ADB's review, the Government will provide relevant information through quarterly reports on the progress and impact of the policy reforms. The consultant engaged by DEA for the PIU will assist the Government in monitoring the policy component. The two tranches are expected to be released to the national Government in two steps, if necessary, the first release being made when the national Government and at least two of the states meet the targets set out in the policy matrix. For the state(s) not meeting the targets, the corresponding amount will be withheld by ADB. Subsequently, additional releases could be made as the concerned state(s) achieve their targets, provided these are met by August 2002 and February 2004. If a state fails to meet its targets, then these portions of the loan will be canceled. A joint final review will be conducted in the second quarter of 2005. The PIU will submit program progress reports, including detailed quarterly reports and the program completion report, to ADB within three months after PSDP completion.

103. The counterpart funds will be disbursed to each state and the national Government under each tranche as shown in Table 4. The distribution reflects the current principle of the

revenue sharing scheme between the national and state governments,<sup>21</sup> the scope and cost of the policy reforms, the importance of the reforms, and each government's financial capacity to sustain an improved level of private sector support services.

**Table 4: Program Loan Tranching and Allocation of Counterpart Funds**  
(\$ '000)

<b>Government</b>	<b>1st Tranche</b>	<b>2nd Tranche</b>	<b>Total</b>
Chuuk	650	650	1,300
Kosrae	400	400	800
Pohnpei	550	550	1,100
Yap	400	400	800
National	500	500	1,000
<b>Total</b>	<b>2,500</b>	<b>2,500</b>	<b>5,000</b>

Source: Staff estimates.

## **B. The Investment Loan**

### **1. Loan Amount , Terms, and Sources of Funds**

104. The sector investments are estimated to cost \$13.032 million equivalent. It is proposed that ADB provide a loan of \$8.017 million equivalent to finance 62 percent of the total cost of the investment Project from its Special Funds resources. The loan will finance the entire foreign exchange cost of \$6.699 million, including interest charges, and \$1.318 million equivalent of the local currency cost equivalent. ADB financing of local currency cost includes primarily civil works for state land offices and BDCs, and staff development activities. The national and state governments will finance the remaining cost of \$5.015 million equivalent (38 percent of the total cost).

105. The investment loan will have a maturity of 32 years including a grace period of 8 years, an interest charge of 1 percent per annum during the grace period and 1.5 percent per annum thereafter on the disbursed and outstanding amounts, and equal amortization. The Government will make the proceeds of the ADB loan available along with local funds to DEA and state government agencies through its regular budgetary allocations. The financing arrangements are summarized in tables 5, 6, and 7, and the details in Appendix 5.

**Table 5: Investment Loan/Cost Allocation**  
**Among the National and State Governments**  
(\$'000)

<b>Cost</b>	<b>National</b>	<b>Yap</b>	<b>Chuuk</b>	<b>Kosrae</b>	<b>Pohnpei</b>	<b>Total</b>
Investment Costs	2,779	1,204	1,780	1,261	994	8,017
Counterpart Costs	1,388	859	1,087	918	763	5,015
<b>Total</b>	<b>4,167</b>	<b>2,063</b>	<b>2,866</b>	<b>2,179</b>	<b>1,757</b>	<b>13,032</b>

Source: Staff estimates.

<sup>21</sup> The current government revenue sharing scheme (except fisheries fees) is 30:70 between the national and state governments.

**Table 6: Investment Loan/Average Annual Government Contribution  
(Recurrent and Incremental Costs)  
(\$'000)**

	<b>National</b>	<b>Yap</b>	<b>Chuuk</b>	<b>Kosrae</b>	<b>Pohnpei</b>	<b>Total</b>
Average Annual Government Contribution	347	215	272	230	191	1,255

Source: Staff estimates.

**Table 7: Investment Loan/Incremental Costs<sup>a</sup>(Without Contingencies)  
(\$'000)**

<b>Cost</b>	<b>National</b>	<b>Kosrae</b>	<b>Pohnpei</b>	<b>Chuuk</b>	<b>Yap</b>	<b>Total</b>
By State						
Total (4 years)	960.00	399.15	266.73	417.93	417.18	2,461.00
Ave. Annual Incremental Budget	240.00	99.79	66.68	104.48	104.30	615.25
		<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>Total</b>
By Year						
Total		452.95	669.35	669.35	669.35	2,461.00

<sup>a</sup>Totals may appear not to add up due to rounding.

Source: Staff estimates.

## **2. Implementation Arrangements and Executing Agency**

106. DOF will be the Executing Agency, responsible for initiating withdrawals under the loan, and for allocating and monitoring the use of loan proceeds. DEA will be the Implementing Agency. A PIU will be established within DEA to support project implementation and ensure that all procurement activities are in accordance with ADB's guidelines. State governor's offices are the Implementing Agencies at the state level. A steering committee, co-chaired by the Secretary of Finance and the Secretary of Economic Affairs, and to include the Governors of the states or their representatives and a representative for each of the COM and FSMDB, shall be established to monitor and coordinate the Program and the Project. A state coordinating committee shall be established at the state level and shall be chaired by the Governor of the relevant state and shall also include other members as determined by each Governor. The state coordinating committee shall monitor and coordinate the Project at the state level.

107. Capacity building of DEA and the role of the PPM are described in paras. 84 and 85.

108. The PPM must have extensive experience in the delivery of public services to the private sector. The services will be required for 24 months over the program-project implementation following loan effectiveness. Specific activities will include (i) design disbursement, procurement, and recruitment procedures and guidelines under the PSDP, and undertake procurement initiatives; (ii) prepare state proposal design and procurement guidelines for the investment project component; (iii) prepare guidelines and support DEA in recruiting consultants using the loan proceeds; (iv) design and activate a national and state implementation and performance monitoring and evaluation system including related training of DEA and state counterpart staff; (v) facilitate the establishment and start-up of national and state steering committees, specifically the BDCs or their equivalent; (vi) assist DEA and national and state steering committees in disseminating information on the improvements and changes under the

PSDP; (vii) train DEA counterpart staff and the state counterpart staff from each agency assigned to manage project implementation; and (viii) support the secretary of economic affairs in providing overall direction to consulting services delivered through the investment component.

### **3. Procurement and Consulting Services**

109. Contracts for equipment and supplies estimated to exceed \$500,000 and contracts for civil works estimated to exceed \$1.0 million will be awarded on the basis of international competitive bidding as detailed in ADB's *Guidelines for Procurement*. Contracts of lower value will be procured on the basis of local competitive bidding, international shopping, or direct purchase as per ADB's *Guidelines for Procurement*. Civil works contracts valued at or below \$1.0 million will be awarded to prequalified contractors in accordance with local competitive bidding procedures acceptable to ADB. Indicative contract packages are attached as Appendix 8.

110. Under the Project, 275.5 person-months of international consulting services in the areas of land administration and management, development banking, business development, and project administration will be required. The international consultants will be engaged in accordance with ADB's *Guidelines on the Use of Consultants* and the domestic consultants will be selected in accordance with arrangements acceptable to ADB. Clear indicators for expected outputs in skills transfer will be set up. Consultants will be selected not only for their technical qualifications, but also for their ability to guide, coach, and mentor local counterparts. Terms of reference of consulting services are shown in Appendix 9.

### **4. Disbursement and Imprest Account**

111. To manage disbursements of loan proceeds, an imprest account will be established by the Government in the Bank of the FSM. The initial amount in the imprest account is not expected to exceed \$100,000. The imprest account will be established, managed, replenished, and liquidated in accordance with ADB's *Loan Disbursement Handbook* dated January 2001, and detailed arrangements agreed upon by ADB and the Government. The imprest account will be operated jointly by the PIU in DEA and DOF.

112. The statement of expenditures (SOE) procedures will be used for reimbursing eligible expenditures under the loan, and for liquidating advances to the imprest account in accordance with procedures acceptable to ADB and consistent with ADB's *Loan Disbursement Handbook*. Any individual payment or contract to be reimbursed or liquidated under the SOE procedure will not exceed the equivalent of \$50,000.

### **5. Advance Action**

113. To expedite Project implementation, ADB has approved advance procurement action to establish the PIU, engage the PPM, and select and recruit consultants. The Government has been advised that ADB's approval of such advance actions will not commit ADB to approve the PDSP subsequently, and no contract can be awarded prior to loan approval.

### **6. Accounts, Auditing, and Reports**

114. The Government will maintain records and accounts adequate to identify goods and services financed from the loan proceeds. The PIU (DEA) and DOF will (i) maintain separate accounts for the Project; (ii) ensure that the accounts and related financial statements are

audited annually in accordance with sound auditing principles by auditors acceptable to ADB; and (iii) submit to ADB, not later than nine months after the close of each fiscal year, certified copies of the audited accounts and the report of the auditor. If necessary, funding will be provided under the loan for auditing project accounts and related financial statements. These funds may be used to outsource auditing services. The PIU will submit project progress reports to ADB including detailed quarterly reports and the project completion report within three months after completion of the Project. The annual audit will include the audit of the imprest account and SOE, and a separate audit opinion on the use of the imprest account and SOE.

## **7. Project Implementation Period and Midterm Review**

115. The Project will be implemented over four years from about February 2002 to February 2006. A review of all aspects of the Project will be carried out by the Government and ADB during the third quarter of 2004. The project midterm review will (i) examine the scope, design, implementation arrangements, and other relevant issues in the light of implementation of the policy component; (ii) evaluate progress toward achieving the measurable project targets and their impacts on private sector development; (iii) identify changes since the time of appraisal relating to sector issues, resource management, and allocations; and reassess their impact on project sustainability; (iv) evaluate implementation performance against the established schedule; (v) verify the compliance with loan covenants; (vi) identify problems and constraints; and (vii) formulate appropriate recommendations for corrective actions. The project implementation schedule is in Appendix 10.

## **8. Performance Monitoring and Evaluation**

116. Outline performance indicators have been identified based on the outputs cited in the budget documents<sup>22</sup> and in accordance with the existing capacity of the concerned agencies (Appendix 11). Beneficiaries highlighted the critical importance of performance measurement. A specific target level is associated with each indicator. Baseline values for some indicators on which information is available are shown for FY2000. Performance indicators and their interim and final target values will be refined by the PIU. Additional indicators will be added at the PSDP objective and goal level in accordance with the program framework. Wherever possible, data will be desegregated by gender, age, and income group. The poverty assessment under an ADB TA for strengthening national statistical capacity and the results of the US-funded FSM 2000 household and population census will provide necessary primary data.

117. The PIU will establish a performance monitoring and evaluation system detailing the qualitative and quantitative output indicators in the Program Framework (Appendix 1) and the outline performance indicators within three months of loan effectiveness. These will also be used to monitor program and project inputs and activities, and will be related to the corresponding impact monitoring. The PPM will undertake this task during the first quarter of implementation, and will report on actual performance through the progress reports. The performance monitoring and evaluation system will be designed in line with the budget preparation of the concerned government agencies.

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<sup>22</sup> The newly introduced output-based budget system is yet to be fully operationalized throughout the national and state agencies. A follow-on ADB TA for strengthening the output-based budget system will commence in late 2001.

## VI. BENEFITS AND RISKS

### A. Expected Impacts

#### 1. Economic

118. The expected economic impacts on the FSM are identifiable at two levels: the effects of the policy loan and the effects of the investment loan. The policy loan aims to develop an economic environment conducive to private sector activity and investment by maintaining the commitment to reforming the public sector and promoting the private sector. Maintenance of financial stability through balanced budgets, the FSM Trust Fund, and sound management of external debt will ensure the macroeconomic stability necessary to create confidence among foreign and domestic investors. Maintenance of government payroll levels will contribute to keeping the budget balanced as well as reducing the differential between government and private wage levels. Public enterprise reform will reduce the budgetary burden on the public sector, improve resource allocation to social and physical infrastructure, and reduce competition with the private sector, enabling the latter to grow more strongly.

119. The PSDP will develop priority areas of the legal and regulatory framework within which improved and lower cost, market-based transactions can increase the competitiveness of resources. Specifically, improved mortgage laws that allow foreign commercial banks to use leasehold mortgage procedures are expected to increase access to capital; extended lease terms are expected to increase the attractiveness of the FSM to long-term investors interested in bringing capital and know-how. Streamlined foreign investment laws and regulations are expected to decrease transaction costs by increasing transparency and eliminating discretionary, and sometimes costly, reviews of applications.

120. The increasing demand for land survey and registration is being driven by a gradual increase in public awareness of the role of land ownership rights for increasing access to financing through commercial loans, and by the need for improved security of lessee rights to encourage domestic and foreign investors. This demand is expected to grow as public understanding of the value of clear land title grows. The investment in improved land management and administration capacity is expected to reduce the costs of surveying and mapping per parcel, and accelerate land surveying and mapping. Currently the cost of surveying and mapping a parcel of land is estimated at approximately \$550. The new equipment and techniques will potentially reduce costs of surveying and mapping to \$30 per parcel and eliminate the problem of backlog accumulation. Experience in Pohnpei with improved survey and mapping technology has shown estimated productivity increases of 200 percent for surveys and 300 percent for map production, with possible further gains through technical training. Accelerated<sup>23</sup> land surveying and titling are expected to increase land transactions including leasing, sales, and use of land to secure lending. Improved registration systems are expected to reduce the time wasted and costs suffered under the current procedures. Improved land valuation is expected to result in a more competitive and efficient land market, allowing transactions to occur at market prices known to both the buyers and sellers of land rights. Increased user right security, especially for lessors, is expected to facilitate increased investment.

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<sup>23</sup> Productivity gains of this magnitude will allow Pohnpei State to clear the current backlog of 1,600 parcels in 2 to 3 years compared with at least 6 years with the technology used in other FSM states.



121. The demand for commercial finance, especially in the start-up and small business sector, is evidenced by the growth in commercial lending in the past 10 years<sup>24</sup> and the high number of commercial loan applications compared with approvals. The lack of response by commercial banks is due to high perceived risks, lack of collateral, and the administration costs of lending to the start-up and small business sector, while inefficiencies in direct government loan schemes have resulted in poor performance of these schemes. FSMDB was identified as the institution most suited to expanding development finance, including longer-term loans at interest rates lower than the commercial banks. The bank is the main source of financing for the agriculture, fisheries, manufacturing, and tourism sectors. Institutional strengthening under the Project will also help FSMDB fulfill its role of higher risk lending to start-ups and small business. The expected benefit is increased access to capital for commercial purposes by informal and small business. The secured transactions legislation and registry system is expected to increase access to commercial finance through chattel mortgaging, which will provide wider access to capital, especially for borrowers who do not have titled land or whose loan amounts are relatively small.<sup>25</sup> Although the value of capital that could be generated by the system is uncertain at this stage, the investment costs for passing a secured transactions law and establishing and operating a secured transactions systems are minimal.

122. Demand for small business support services has been demonstrated through the MEDC program and the high level of participation in MEDC training and services in the areas of entrepreneurship, business proposal preparation, and aspects of business management.<sup>26</sup> Unmet service demand exists in post-start-up advisory services, business information services, services for informal business, and locationally disadvantaged groups. The relocation of the present business centers to state COM campuses (Yap excepted) is expected to improve efficiency, allow access to additional and better qualified staff and other resources, and allow the development of a more effective outreach program to reach the locationally and economically disadvantaged.

123. Given the limited growth prospects for the nontraded sectors such as the wholesale and retail trade, future private sector growth in the FSM is expected to be mainly in the tradable sectors including fisheries, tourism, agriculture, and light manufacturing. Expansion into the traded sectors is expected to be driven by foreign direct investment and informal and formal SMEs. The extent to which the PSDP facilitates increased private sector activity will be measured by the increase in business licenses, company registration, and foreign investment applications. The with and without effects of proposed policy and legal actions and project components are provided in Appendix 12.

## **2. Poverty and Social Impact**

124. The PSDP will contribute to ongoing changes and evolution in traditional systems in the FSM society and economy, the most important of which are the changes from a subsistence

<sup>24</sup> Since 1990 total loans of the commercial banking sector have increased from a level of \$29 million to \$50 million by the end of the third quarter in 1999.

<sup>25</sup> The demand identified for very small business loans is generally not handled by any of the formal banks. This demand was found among low income and disadvantaged groups including outer islanders and groups living outside the state urban centers.

<sup>26</sup> Of the 237 businesses interviewed during the project preparatory TA, about 50 percent of the enterprises have participated in training programs. Entrepreneurship or management training and accounting/bookkeeping are the training most demanded; 95 percent of the respondents feel that the training has benefited their enterprises, mainly through an improvement in their business and upgrading of employee skills. Eighty-five percent of respondents felt they needed training, by order of preference, in: business skills (such as in marketing, customer service, etc.), entrepreneurship and management, accounting/bookkeeping, and technical skills.

economy to a market economy, community ownership of land to individual ownership, membership in extended lineages and clans to the nuclear family, and greater individualism in social life and economic activity. The evolution of land tenure and rights has proved especially difficult for the FSM. The major social issues surrounding land include land disputes within clans, the increasing inability of traditional leaders to settle disputes; exploitation due to ignorance surrounding land values; the protection of lessee and lessor rights; and the disincentive to investors owing to lack of clarity of title and rights. These ongoing changes have carried social costs, but as evidenced by the changes over the past 20 years, this is a choice that Micronesian society has made for the sake of adopting a more modern lifestyle, self-sustaining economic growth, and better social services. The extent to which the FSM's different ethnic groups have adopted these changes while maintaining traditions varies considerably, as does the extent to which the changes have caused social problems. By providing better-targeted services to members of FSM society who have been bypassed by recent economic change, more equitable opportunities for economic and consequently social improvement will likely be provided.

125. The poverty impact of the PSDP on disadvantaged and low income groups will be positive overall, both directly and indirectly, as detailed in Supplementary Appendix B. Essentially, the various components of policy and project loans will act through the following three channels: (i) promote overall growth through private sector development leading to increased employment and income; (ii) channel a large share of the project benefits to the main low income and poverty groups to ensure that they can use the enhanced services and contribute to and benefit from economic growth; and (iii) assist the government to increase the focus of public expenditure on social services by promoting non-public-sector dependent, private-sector driven economic growth.

126. The investment Project's allocations support all states, but given that more than half of Chuuk's population is poor, it will benefit from a proportionately higher portion of services to be developed under the Project, as will the poor in other states. The business development and FSMDB components will emphasize reaching the disadvantaged and low-income groups: the outer islanders and dislocated migrants now living in the district centers. The latter group, for example, are suited to being assisted with non-land-based activities, such as local food processing for which domestic and regional export market demand is increasing (e.g., Guam). Proactive land survey and titling in the outer islands, where the demand is strong, will also prevent migration to the main islands by enabling investments in housing and income-earning sectors such as fisheries, agriculture, and tourism in the outer islands.

127. While women have traditionally deferred to men in FSM society, they are steadily closing the gender gap in terms of educational attainment and participation in the nonsubsistence labor force (in which their share has grown to a third, almost doubling in the last three decades). By seeking to involve women in small businesses, the Project builds on their traditional productive role as weavers and makers of community valuables. It also seeks to revitalize informal community women's organizations for delivery of credit, training, and marketing. The increase in the number of land titles, including those held by women, will make it easier for women to access the banks directly, instead of relying on male relatives.

128. Young males are disentangling themselves from traditional household obligations faster than their sisters, who still have a secure place in the family.<sup>27</sup> By extending the Project's

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<sup>27</sup> The suicide rate for the general population is among the highest in the world, and in some islands exceeds 200 per 100,000 for males aged 15-24. The spread of the market economy, which allows independent access to cash-

business development activities to school dropouts and other youth-at-risk, and thereby giving them an alternative focus in life, the Project will help to address the considerable issue of unemployed and out-of-school youth in the FSM.

## **B. Risks and Safeguards**

### **1. Weak Political Will for Reforms**

129. The Government's political commitment could weaken, resulting in delay in implementing the reform measures. The complex political structure may also result in uneven performance in policy reform and project implementation among the four states. A national and state jurisdictional issue over the secured transaction law may lead to varying content and implementation, and even disagreement on legal changes.

130. Government commitment is reflected in the results of the Second FSM Economic Summit; EPIC will oversee key issues of economic reform. The policy actions and the time frame in the policy matrix reflect each state's financial and legal situation, and local acceptance and capacity for implementing reforms. Tranching strategy of the policy loan is designed to prevent delay of loan release at the expense of the states that are able to meet the conditions. All areas of proposed legislative and regulatory change have been raised recently in government or state legislatures, and attempts have already been made to draft bills. The proposed national secured transaction law under ADB (footnote 18) TA presented an approach to resolve the jurisdictional issue satisfactorily for both the national and state governments. The states, while protecting their jurisdictions, have also shown a willingness to consider changes that have proved to be successful in other states.

### **2. Effectiveness of Public Administration and Judiciary**

131. Institutional capacities of and coordination between various government agencies are generally weak. FSMDB and the SBDCs have limited capacity for outreach to large numbers of inexperienced potential business people. Institutional capacity to enforce legislation through the courts is insufficient. If a mechanism for accelerating the settlement of land disputes is not realized, this will diminish the potential benefits from improved surveying and mapping technology. Moreover, an attempt to accelerate surveying and mapping without an effective dispute settlement mechanism may accentuate disputes.

132. DEA and the state governments have implemented the ADB-funded PSRP since 1997, and will be strengthened through on-the-job training for three years by an international PPM. Careful planning and monitoring will enable DEA to implement the investment Project effectively. In particular, advance procurement action and retroactive financing will be available for selecting and recruiting consultants, establishing the PIU, and engaging the PPM in order to ensure timely implementation. The need for judiciary training and court management is well recognized and the Government is expected to address this need in the short- and medium-term through ADB and other external assistance. In the states where land dispute settlement is a prominent issue, consulting services for establishing an effective settlement mechanism will be provided prior to physical investments.

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incomes, has led to a weakening of the traditional father-son relationship. Most suicides have to do with anger and deep disappointment at the rupture of a close relationship with a respected family elder such as the father or brother. The ratio of male to female suicides is reported to be 14:1.

### **3. Weak Response from the Private Sector**

133. Increased lending and business support to small business may not increase the number and performance of new and existing businesses due to a lack of viable business opportunities and ineffective training and business advisory support. Strengthened legal systems may not result in increased foreign investments and increased leasehold and mortgage transactions. Small businesses may not perform sufficiently to repay loans and minimize defaults.

134. State BDCs will oversee the performance of the SBDCs; and facilitate their interaction with NGOs, FSMDB, and the Government to provide integrated business support services. The labor market information system to be operated by the SBDCs will help increase awareness of job opportunities. Recent FSMDB data show that small loans under \$1,000 do not experience loan recovery problems. Improved skills and management in examining loan proposals will prevent a deterioration of FSMDB's loan recovery rate.

### **4. Affordability and Sustainability**

135. With the impending review of Compact funding, the possible reduction of external transfers may prevent the Government from mobilizing the increased expenditures anticipated. Incremental recurrent costs may not be financed sufficiently and on a timely basis by the national and state governments.

136. Sound fiscal management and external debt management will enable the Government to make available the required resources to sustain the improved level of public services beyond the project implementation period. In particular, the FSM Trust Fund, if fully operationalized, will generate additional revenues for the governments to support the increased recurrent costs.

## **VII. ASSURANCES**

### **A. Specific Assurances**

137. The Government has given the following assurances, in addition to the standard assurances, which have been incorporated in the legal documents:

- (i) The Government will (a) maintain the policies adopted and actions taken prior to the date of the Loan Agreement for the policy loan, as described in the development policy letter (Appendix 2) and the policy matrix (Appendix 3), for the duration of the PSDP policy loan period; and subsequently, (b) promptly adopt the other policies and take the other actions included in the PSDP as specified in the development policy letter and the policy matrix (including the conditions for release of the second tranche as described in the policy matrix); and (c) ensure that such policies and actions continue in effect for the duration of the policy loan period.
- (ii) The Government will ensure FSMDB implements a new corporate plan focusing on business promotion, customer service, financial sustainability, and human resources development. FSMDB will develop the existing system of management by objectives with each state branch setting lending, collection, and profit objectives.

- (iii) In each state, the SBDC will be advised by a BDC that will have representatives from the private sector, banks, COM, NGOs, and the state government. The BDC will replace the current Micronesian Entrepreneur Development Center Board. The Government will aim at having the SBDCs become self-sustaining organizations by causing them to charge fees for their training and advisory services, as appropriate, and to receive funds from other external sources.
- (iv) The Government will introduce nominal charge for certain activities associated with first registration activities while full charges shall be levied for secondary transactions in land rights, such as leases and the recording and registering of mortgages. As the land administration systems become established, fee structures for land titling shall be reviewed with a view to increasing cost recovery for the systems.

## **B. Conditions for Loans Effectiveness**

138. **Common Condition for the Policy and Investment Loans.** At least two states will each have executed and delivered its relending agreement to the Borrower, and such relending agreement, in form and substance acceptable to ADB, will have been duly authorized or ratified by all necessary government action at the state and national level; and all conditions precedent to the effectiveness of the relending agreements (other than a condition requiring the effectiveness of the Loan Agreements) will have been fulfilled.

139. **Policy Loan Effectiveness.** All conditions precedent to the effectiveness of the investment Loan Agreement (other than a condition requiring the effectiveness of the policy Loan Agreement) are fulfilled.

140. **Investment Loan Effectiveness.** Effectiveness will be subject to the satisfaction of the following special conditions:

- (i) All conditions precedent to the effectiveness of the policy Loan Agreement (other than a condition requiring the effectiveness of the investment Loan Agreement) are fulfilled.
- (ii) A PIU is established within DEA, with a PPM and local counterpart staff, satisfactory to ADB.

## **C. Conditions for Disbursement of the Investment Loan**

141. For disbursement of certain components of the investment loan, the following conditions will be met:

- (i) The new FSMDB corporate plan will be put into effect.
- (ii) The business development act will be enacted in Chuuk, Kosrae, and Yap; and the current Pohnpei business development act will be amended.
- (iii) Land sites will be made available for construction of new buildings of land administration (Chuuk, Kosrae, and Yap) and SBDCs (Chuuk, Kosrae, and Pohnpei).

### **VIII. RECOMMENDATION**

142. I am satisfied that the proposed loans for the Private Sector Development Program would comply with the Articles of Agreement of ADB and acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve

- (i) the loan in various currencies equivalent to Special Drawing Rights 3,912,000 to the Federated States of Micronesia for the Private Sector Development Program, with a term of 24 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement (Private Sector Development Program) presented to the Board; and
- (ii) the loan in various currencies equivalent to Special Drawing Rights 6,273,000 to the Federated States of Micronesia for the Private Sector Development Project, with a term of 32 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement (Private Sector Development Project) presented to the Board.

MYOUNG-HO SHIN  
Vice-President

16 November 2001

## APPENDIXES

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## SUPPLEMENTARY APPENDIXES

(available upon request)

- A The Investment Project
- B Poverty and Social Impact Assessment

## PROGRAM FRAMEWORK<sup>a</sup>

Design Summary	Performance Targets	Monitoring Mechanism	Assumptions and Risks
<b>1. Goal</b> Increase sustainable economic growth in the FSM through an increased contribution of the private sector.	<ul style="list-style-type: none"> <li>GDP and employment through the private sector increase during and after program/project implementation</li> </ul>	<ul style="list-style-type: none"> <li>National accounts, DEA labor force and household income surveys</li> <li>DEA economic reports</li> <li>IMF Article IV mission reports</li> </ul>	Future compact transfers will not be significantly lower than current levels.  No natural disasters occur.
<b>2. Overall objective</b> 2.1 Develop a sound economic and legal environment conducive to private sector development.	<ul style="list-style-type: none"> <li>Investor confidence improves in FYs 2002/04</li> <li>Number of businesses significantly increases in FYs 2002/04</li> <li>Performance of businesses improves in FYs 2002/04</li> </ul>	<ul style="list-style-type: none"> <li>Annual rapid "quick and easy" (Q&amp;E) business survey</li> <li>Social security records</li> <li>Business registration records</li> </ul>	Private sector and investors respond to the opportunities presented by an improved economic and regulatory environment and support services in the FSM.
2.2 Improve access to and competitiveness of land, labor, and capital resources to increase business prospects and performance.	<ul style="list-style-type: none"> <li>Number of land lease and mortgage transactions increases in FYs 2002/04</li> <li>Number and volume of loans to the private sector including SMEs by banks increases in FYs 2002/04</li> </ul>	<ul style="list-style-type: none"> <li>Land registration records</li> <li>FSMDB annual report</li> <li>FSM banking board reports</li> </ul>	Continued support and commitment by the national and state government legislative and executive branches to PSDP policy actions
<b>3. Outputs</b> 3.1 Continued economic and legal reforms	<ul style="list-style-type: none"> <li>Balanced budgets maintained</li> <li>Wage differential between the public and private sector is reduced</li> <li>Additional Compact funds are contributed to the FSM Trust Fund</li> <li>External debt is kept at below 24 percent of GDP</li> </ul>	<ul style="list-style-type: none"> <li>Annual national and state budget papers</li> <li>Governments' payroll data</li> <li>DEA national accounts statistics</li> <li>Progress reports of Public Enterprise Unit in DEA</li> <li>Gazetting of relevant legislation</li> <li>DEA economic reports</li> </ul>	

DEA = Department of Economic Affairs, FSM = Federated States of Micronesia, FSMDB = FSM Development Bank, FY = fiscal year, GDP = gross domestic product, IMF = International Monetary Fund, Q&E = "quick and easy," PSDP = private sector development program.

<sup>a</sup> Specific time-bound outputs are detailed in the Policy Matrix (Appendix 3) and the Performance Monitoring and Evaluation Indicators (Appendix 11).



Design Summary	Performance Targets	Monitoring Mechanism	Assumptions and Risks
	<ul style="list-style-type: none"> <li>Public sector enterprise reforms are implemented</li> <li>Long-term land lease laws are enacted</li> <li>Mortgage law enacted</li> <li>New foreign investment laws are enacted and application procedures made effective</li> </ul>		
3.2 Improved public services to support private sector development			
3.2.1 A new secured transactions system	<ul style="list-style-type: none"> <li>A modern secured transaction law is enacted</li> <li>A secured transaction registry established within the land administrations</li> <li>Bankruptcy laws enacted</li> </ul>	<ul style="list-style-type: none"> <li>Gazetting of relevant legislation</li> <li>Registry annual reports</li> </ul>	National and state governments resolve jurisdictional issues on secured transactions laws.
3.2.2 Strengthened state land administration and management	<ul style="list-style-type: none"> <li>Number of land titles increases</li> <li>Land disputes decrease</li> <li>Backlog of land dispute settlement cases decreases</li> <li>Number of land titles for women and outer islands increases</li> </ul>	<ul style="list-style-type: none"> <li>Surveys of public satisfaction</li> <li>Land and chattel registration records</li> <li>Annual reports of land tenure courts</li> </ul>	Use of appropriate technology and absorption capacity of land staff in training
3.2.3 Strengthened capacity of FSMDB	<ul style="list-style-type: none"> <li>Visits of state FSMDB branches to outer-islands increase</li> <li>Loans in arrears decrease</li> <li>FSMDB operations are decentralized to state branches</li> <li>Number of business training and advice by FSMDB increases</li> <li>Number and share of small loans increases</li> <li>Number and share of loans to SMEs, women and outer island businesses increase</li> </ul>	<ul style="list-style-type: none"> <li>Minutes of FSMDB board of directors</li> <li>Annual rapid Q&amp;E business survey</li> <li>FSMDB bulletin</li> <li>FSMDB annual report</li> </ul>	<p>Absorption capacity of FSMDB staff in training</p> <p>Small businesses perform sufficiently to repay loans and minimize defaults.</p> <p>Opportunities exist for private sector growth on the outer islands.</p>

SME = small and medium enterprises.

Design Summary	Performance Targets	Monitoring Mechanism	Assumptions and Risks
3.2.4 Improved business development services of SBDCs	<ul style="list-style-type: none"> <li>SBDCs are converted from government bodies into nonprofit independent agencies</li> <li>Number of business trainees by SBDC increases</li> <li>The range of business skills training and advisory support is expanded</li> <li>An integrated labor market information system is established</li> <li>Visits of SBDC staff to outer islands increase</li> <li>BDCs are established</li> </ul>	<ul style="list-style-type: none"> <li>SBDC annual reports</li> <li>Annual rapid Q&amp;E business survey</li> </ul>	Qualified local staff is available to reach to large numbers of inexperienced potential business people
<b>Activities:</b> 4.1. Economic policy and legal environment creation  Specific time-bound activities are detailed in the policy matrix (Appendix 3).  4.2. Institutional capacity building  Specific time-bound activities are detailed in the investment project implementation schedule (Appendix 10)	<ul style="list-style-type: none"> <li>Counterpart funds generated from \$4 million program loan</li> <li>National and state governments' achievements in reforms assisted by the program manager</li> </ul>	<ul style="list-style-type: none"> <li>Progress reports of the PIU</li> </ul>	Government commitment to changes  Implementation of new laws and regulations
4.2.1 Civil works	<ul style="list-style-type: none"> <li>New buildings of land administration offices in Chuuk and Yap, and rehabilitation in Kosrae and Pohnpei</li> <li>Building of SBDCs in Chuuk, Kosrae, and Pohnpei and renovation in Yap</li> </ul>	<ul style="list-style-type: none"> <li>Consultants' workplan</li> <li>PIU's progress reports</li> </ul>	Land offices agree to house the secured transactions system  Cost estimates for the Project are sufficient  Availability and timeliness of inputs
4.2.2 Equipment and materials	<ul style="list-style-type: none"> <li>Computers for land administration, FSMDB, and SBDC</li> <li>Vehicles for land administration</li> </ul>		No major price or demand or demand deviation from project forecast  Appropriation of sufficient government funds

BDC = business development center, PIU = program-project implementation unit, SBDC = Small Business Development Center.

Design Summary		Performance Targets	Monitoring Mechanism	Assumptions and Risks
4.2.3	Consulting services	<ul style="list-style-type: none"><li>• Survey, mapping, and archival equipment in Chuuk, Kosrae, and Yap</li><li>• 275.5 person-months (4.5 for legal experts, 53 for land experts, 32 for development bank experts, 162 for small business support experts, and 24 for program manager)</li></ul>		Assignment of sufficient government staff to the Project

## **DEVELOPMENT POLICY LETTER**

September 19, 2001

Mr. Tadao Chino  
President  
Asian Development Bank  
0980 Manila, Philippines

Dear Mr. Chino:

### **Re: FSM Private Sector Development Program Development Policy Letter**

The Government of the Federated States of Micronesia (FSM) has been engaged in a comprehensive economic Policy Reform Program, with the support of the Asian Development Bank (ADB), since 1996. The two-pronged approach of our overall economic strategy is designed to reduce the role of the public sector in the economy and increase private sector output to ultimately achieve economic self-reliance. Both the Government and ADB assessed the recently completed Public Sector Reform Program (PSRP) as having been generally successful. However, a considerable reform agenda remains. Substantial cuts in the size and cost of government have been achieved but structural change toward greater private sector employment and development is slow to occur due to fundamental constraints in the FSM's economic resources and markets, support services and legal environment. The Private Sector Development Program (PSDP), as an important element of our broader reform program, is designed to help the FSM establish an open and competitive economy that is conducive to private sector development by promoting a favorable macroeconomic and legal environment for investment, and increasing the mobilization, productivity and competitiveness of FSM's land, labor and capital resources.

The broad economic policy framework that guides the Government's overall economic reform efforts was developed at the Second FSM Economic Summit in September 1999. Subsequent to that, ADB has contributed significantly to the development of the PSDP that will enable the National and State Governments of the FSM to implement a broad range of macroeconomic and microeconomic reforms consistent with the results of that Summit. The PSDP, to be jointly funded with Bank support, represents a timely and necessary combination of two components: first, a policy reform component, and second a sector development project that will focus financial and technical resources to implement reforms and support institutional strengthening.

Since developing the broad outlines of the PSDP towards the end of 1999, the FSM National and State Governments were thoroughly engaged in the program design work of the PSDP with the PPTA consulting team, and worked closely with Bank staff. The major elements of the PSDP were presented for deliberation at the FSM Economic Policy Implementation Council and the policy leaders of the nation demonstrated their support for the PSDP through unanimous support of those present for EPIC Resolution 2000-1-01. We anticipate approval of the National-State Financial Agreements immediately following authorization of the PSDP loan by the Congress of the FSM in the session that commences in October 2001.

### **Objectives and Scope of the Private Sector Development Program**

The Government, with advice from the ADB-supported PSDP PPTA Consulting Team and with background advisory support of the Economic Management Policy Advisory Team (EMPAT), has developed an action-oriented, time bound approach to the implementation of those elements of the nation's overall economic reform program related to accelerating private sector development. This program is already underway and the policy reforms required are, in many cases, being implemented or considered on a timely basis; however, a range of activities await implementation of the ADB-supported PSDP.

The overall objective of the PSDP is to establish an economic and legal environment conducive to competitive, private sector-led economic growth. Specific objectives are to:

- ❖ consolidate public sector and economic reform policies that support private sector development;
- ❖ improve the legal and regulatory environment that influences access to and mobilization of economic resources by the private sector;
- ❖ increase access to and security of land for economic use;
- ❖ increase access to finance needed for business start-up and expansion of small and medium sized enterprises (SMEs);
- ❖ improve business and entrepreneurial skills in small and medium size enterprises and in the informal sector;
- ❖ strengthen the institutional capacity in the Department of Economic Affairs to implement the PSDP.

### **The Policy Component**

The policy component includes the consolidation of economic reform policies, passage of legal provisions that favor private sector development, and assurance of future funding for accomplishing required reform measures to promote private sector development.

### **First Tranche Policy Actions**

Under the broad objective of maintaining economic and public sector reforms, actions will be taken in five areas before the release of the first tranche under the program loan:

1. Each of the five governments is committed to have a balanced budget for fiscal year 2002.
2. Each government is committed to a wage bill target for fiscal year 2002 which shall not exceed the following amounts:
 

a. National:	\$ 8.41 million
b. Chuuk:	\$15.94 million
c. Kosrae:	\$ 5.80 million
d. Pohnpei:	\$12.90 million
e. Yap:	\$ 4.51 million
3. The FSM National Government, on behalf of all five governments, will ensure that the FSM Trust Fund law is passed and the Board established.
4. The FSM National Government, in coordination with the State Governments, is committed to ensure that total FSM official external debt, net of assets held for loan repayment, does not exceed 24 percent of GDP in fiscal year 2002.
5. Each of the five governments has committed that Public Enterprise Reform Draft Master Plans are completed. At a minimum this will result in the transformation of five public enterprises and, more optimistically, will result in appropriate and efficient transformation of all of the FSM's public enterprises by the end of the program period.

Under the broad objective of improving the legal environment for private sector development actions will be taken in two additional areas before the release of the first tranche:

6. Each of the five governments has committed to draft legislation to improve the legal environment for long(er) term leasing of land and for encouraging mortgage-secured commercial lending.

## Second Tranche Policy Actions

Actions will also be taken before the release of the second tranche under the program loan:

1. The budgets of the five governments will be balanced in fiscal years 2003 and 2004.
2. The increase of the wage bill targets referred to above for each government will not exceed 1.5 percent in fiscal year 2003 and a further 1.5 percent in fiscal year 2004.
3. In the event of a two year extension of the economic provisions under the FSM Compact of Free Association with the United States, at least 50 percent of the increase of budgetary support under the Compact base grant for fiscal year 2002 and 2003 will be placed into the FSM Trust Fund referred to above. The FSM Trust Fund will be fully operational.
4. The FSM official external debt, net of assets held for loan repayment, will not exceed 24 percent of GDP in fiscal years 2003 and 2004.
5. At least one public enterprise will be transformed by each of the five governments.

The following legislative actions will be taken before the release of the second tranche:

6. The long term leasing of land and the mortgage-secured commercial lending draft legislation referred to above will be enacted in each State.
7. The foreign investment draft amendments referred to above will be enacted by the National Government and each State and regulations will be promulgated.

## The Investment Project Component

The investment project is designed to improve the performance of the public sector in efforts to promote private sector development. The investment project includes three components:

1. **Establishment of a nationwide secured transactions system:** this will involve the passage of an umbrella national law, as well as, perhaps, State laws consistent with the commitment to promote chattel mortgage secured commercial lending. All five governments are committed to establishing a unified and comprehensive FSM Registry. A separate commitment has been made by the five Governments to participate in a Bank-supported consultancy to identify, and subsequently enact balanced and appropriate bankruptcy laws.
2. **Strengthening of Institutional Capacity to Support Private Sector Development:** this component will entail capital investments and consulting services in the following three areas.
  - a. **Land Administration and Management:** the four State governments have committed to a program of advisory support, training, and capital investment to: (i) promote the modernization and development of land registration systems, (ii) expedite the issuance of land titles, (iii) develop appropriate institutions and procedures for dispute resolution, (iv) develop appropriate systems for zoning and land use management, and (v) develop capacity for land valuation.
  - b. **Financial Services to the Private Sector:** the legal and regulatory reforms outlined above will address the needs of the commercial banking sector to increase commercial lending; however, the FSM Development Bank (FSMDB) has further committed to a program of institutional strengthening to enhance its ability to focus effectively on small and medium-size business promotion and customer service. The FSMDB has committed to updating its Corporate Plan accordingly and to implement a long-term, integrated capacity building program to improve its human resource skills base and to improve its long-term financial viability.

- c. **Small Business Development Services:** the National Government and four State governments have committed to supporting the extension, expansion and re-formulation of the activities formerly provided under the Micronesian Entrepreneurial Development (MEDC) program. The strengthened program will be renamed as Small Business Development Centers (SBDC) and will also incorporate a labor market information system.
3. **Program and Project Implementation:** the National Government has committed to establish a Project Implementation Unit (PIU) within the implementing agency. The FSM Department of Economic Affairs will be strengthened in its ongoing role as a conduit for significant donor assistance activities in support of sectoral development and economic management.

## CONCLUSION

Financial and technical support from ADB in conjunction with determined efforts and sustained commitment on the part of the five Governments in the FSM will ensure progress toward our stated goals. The National Government is committed to fully implement the comprehensive policy actions as delineated in the attached policy matrix. Many of these steps have already been taken and the timetable expressed in the Policy Matrix represents a firm commitment to achieve the remaining actions. Given the complexity of our Federal Government structure, the National Government will monitor performance across all five Governments. The policy-level monitoring will be the primary responsibility of the Department of Economic Affairs. The staff economists within the Policy division of that department will provide the technical expertise to support program implementation and monitoring, in conjunction with the EMPAT advisers with whom they work. The Department of Economic Affairs, as the implementing agency, will also provide a full-time project implementation specialist within its project implementation unit to effectively facilitate the use of the complex set of technical and financial inputs anticipated under the PSDP. It is further understood that, while the policy loan effectivity will be a condition for project loan effectivity and vice versa, each of the investment project components will proceed according to detailed project timelines and subject to the specific, project-related commitments undertaken by each government.

Representing the borrowing entity, the executing agency will be the National Department of Finance and Administration. It should be clear that the conditions agreed to in the policy matrix for each Government will be binding only on that Government. I do not anticipate any failures to meet the stated conditions for tranche release; however, the unanticipated problems of any individual Government should, to the maximum extent possible, not cause ADB to delay the release of finances to those Governments that have fully met the conditions to which they committed. The FSM Government views the PSDP as a second phase in our successful and ongoing effort in conditioned collaboration with ADB and other donors who may be contributors of financial and/or technical support.

Yours sincerely,

John Ehsa  
Secretary of Finance and Administration

## POLICY MATRIX

The First Tranche will be disbursed at loan effectivity. The Government will have registered adequate progress by November 2001 and this is described in the Development Policy Letter. The actions listed in the Policy Matrix must be fulfilled to the satisfaction of ADB as conditions for Board consideration (first tranche release) and second tranche release. The two tranches will be released to the national Government in two steps if necessary, the first tranche being released when the national Government and at least two of the States meet the targets set out in the Policy Matrix. For the state(s) not meeting the targets, the corresponding amount will be withheld; subsequently releases could be made as the state(s) achieve their targets, provided these are met by August 2002 and February 2004. If a state fails to meet its targets, then these portions of the loan will be canceled.

Policy			Conditions for Board Consideration	Actions to be Taken Prior to Second Tranche Release (August 2003)	Targets for End of Program Period
<b>Section 1: Maintain Economic and Public Sector Reforms</b>			Enactment of legislation authorizing the FSM National Government to borrow from ADB (Completion Date: October 2001)		
All	1a	Maintenance of balanced budgets	Balanced budget for FY2002 on total current revenues and grants based on FY2001 levels less current expenditures for national and participating state governments (Completion Date: October 2001)	Continued implementation in FY2003 and FY2004	Fiscal position of the five governments is strengthened with level of financial reserves maintained or increased
All	1b	Maintenance of government payroll levels and reduction of public to private sector wage differentials	Wage bill of the national and each participating state governments in FY2002 will be passed by the respective legislative branch with amounts not exceeding: National: \$8.41 million Kosrae: \$5.80 million Pohnpei: \$12.90 million Chuuk: \$15.94 million Yap: \$4.51 million. (Completion Date: October 2001)	Continued maintenance of wage bill restraint with annual increases not exceeding 1.5% in FY2003 and FY2004.	Real wage bill reduced and nonwage operating expenditures enabled to increase as a share of total expenditures



Policy			Conditions for Board Consideration	Actions to be Taken Prior to Second Tranche Release (August 2003)	Targets for End of Program Period
N (Dec. 2001) All(Aug. 2003)	1c	Sound management of the FSM Trust Fund	The FSM Trust Fund law is passed and the Board is nominated. (Completion Date: November 2001)	Not less than 50% of the increase of budgetary support under the Compact Base Grant for FY2002 and FY2003 dedicated to the Stability Account of the FSM Trust Fund  FSM Trust Fund fully operational	Temporary increase in transfers does not excessively inflate recurrent expenditures, and increased FSM Trust Fund balance improves medium-term sustainability of government services
All	1d	Sound Management of external debt	Total official debt, net of assets held to secure repayment, remains below 24% of the national GDP in FY2001 (Completion Date: October 2001)	Continued maintenance of official debt remains below 24% of GDP in FY2002 and FY2003	FSM external debt position is improved, enabling the nation to safely liberalize its external debt policy after Compact economic assistance provisions are renewed
All	1e	Progress in public enterprise reforms	Draft master plans for public enterprise reform completed (Completion Date: September 2001)	Master plans for public enterprise reform are submitted to each participating government.  At least one public enterprise is transformed by each government.	Successful transformation of at least five public enterprises provides models for progress and reduces the role of government in commercial activities

Policy			Conditions for Board Consideration	Actions to be Taken Prior to Second Tranche Release (August 2003)	Targets for End of Program Period
<b>Section 2: Improve Legal Environment for Private Sector Development</b>					
S	2a	Improvement of legal environment promoting the use of land and property as loan security	Long-term land lease legislation drafted	Long-term land lease legislation passed	Land lease term no longer cited as an impediment to long-term investment
			Mortgage legislation draft (Completion Date: September 2001)	Mortgage legislation passed	Banks have increased mortgage-secured commercial lending
All	2b			Foreign investment laws amended and/or regulations are implemented	Streamlined and transparent foreign investment laws and regulations are operationalized

Key:

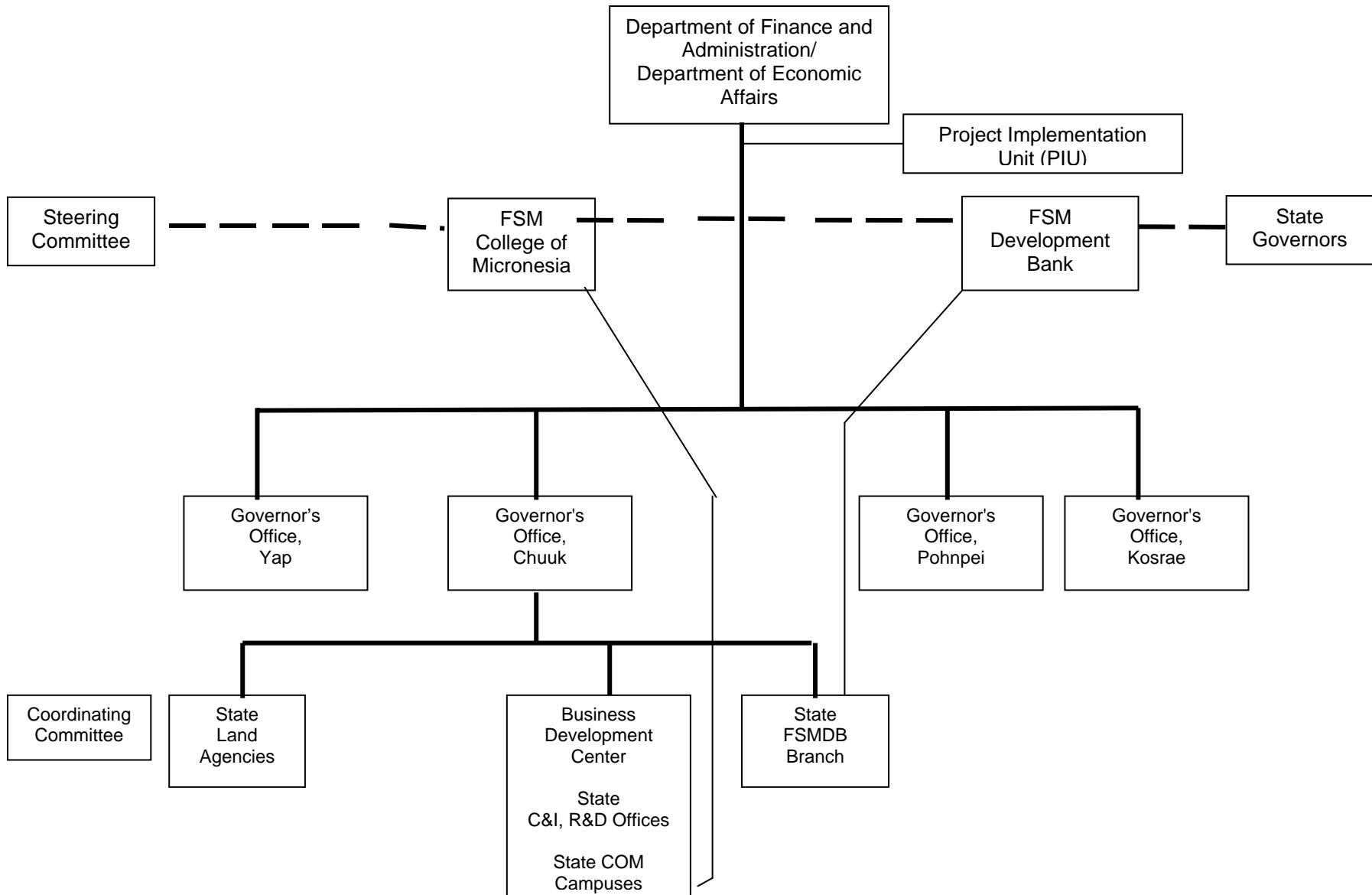
N: National Government

All: National Government, Kosrae State, Pohnpei State, Chuuk State, and Yap State

S: Kosrae State, Pohnpei State, Chuuk State, and Yap State

# FEDERATED STATES OF MICRONESIA-PRIVATE SECTOR DEVELOPMENT PROGRAM ORGANIZATIONAL STRUCTURE

Implementation  
Structure



**COST ESTIMATES AND FINANCING PLAN****Table A5.1: Detailed Base Cost Estimates**  
(\$'000)

<b>Base Costs</b>	<b>Foreign Currency</b>	<b>Local Currency</b>	<b>Total Cost</b>
A. Secured Transactions System	111	184	295
1. Consulting services	90	20	110
2. Equipment and materials	21	0	21
3. Operating costs	0	164	164
B. Institutional Capacity Building	5,405	5,203	10,608
B.1 Land Administration and Management	2,926	2,314	5,239
1. Consulting services	1,016	220	1,236
2. Equipment and materials	1,328	0	1,328
3. Operating costs	0	1,900	1,900
4. Civil works	581	194	775
B.2 FSMDB Services	491	172	663
1. Consulting services	441	97	538
2. Equipment and materials	50	0	50
3. Operating costs	0	75	75
B.3 Small Business Development Centers	1,989	2,717	4,706
1. Consulting services	610	92	702
2. Equipment and materials	464	0	464
3. Operating costs	0	2,320	2,320
4. Civil works	915	305	1,220
C. Project Implementation Support	456	370	826
1. Consulting services	406	270	676
2. Equipment and materials	50	0	50
3. Operating costs	0	100	100
<b>Subtotal (A+B+C)</b>	<b>5,973</b>	<b>5,757</b>	<b>11,730</b>
D. Contingencies			
1. Physical	418	403	821
2. Price	179	173	352
<b>Subtotal (D)</b>	<b>597</b>	<b>576</b>	<b>1,173</b>
Interest Charge	129	0	129
<b>Total</b>	<b>6,699</b>	<b>6,333</b>	<b>13,032</b>

FSMDB = Federated States of Micronesia Development Bank.

Source: Staff estimates.

**Table A5.2: Detailed Financing Plan for Project Loan Under the Private Sector Development Program**  
(\$'000)

Components	ADB Financing			Foreign Currency	FSM Government Financing					FSM Subtotal	Total
	Foreign Currency	Local Currency	ADB Subtotal		National	Yap	Local Currency Chuuk Kosrae Pohnpei				
A. Secured Transaction Center	122	22	144	0	75	26	26	26	26	180	325
Equipment and Materials	23	0	23							0	23
Consultancy	99	22	121							0	121
Operating Costs		0	0		75	26	26	26	26	180	180
B. Capacity Building	5,946	999	6,945	0	1,247	822	1,049	881	726	4,724	11,669
B.1 Land Administration and Management	3,218	455	3,673	0	171	454	615	557	292	2,090	5,763
Civil Works	639	213	853							0	853
Eqpt and Materials	1,461	0	1,461							0	1,461
Consultancy	1,118	242	1,359		171	454	615	557	292	2,090	1,359
Operating Costs	0	0	0							0	2,090
B.2 FSMDB											
Strengthening	540	107	647	0	20	16	16	16	16	83	729
Eqpt and Materials	55	0	55							0	55
Consultancy	485	107	592							0	592
Operating Costs	0	0	0		20	16	16	16	16	83	83
B.3 Small Business											
Development Center	2,188	437	2,625	0	1,056	352	418	308	418	2,552	5,177
Civil Works	1,007	336	1,342							0	1,342
Eqpt and Materials	510	0	510							0	510
Consultancy	671	101	772							0	772
Operating Costs	0	0	0		1,056	352	418	308	418	2,552	2,552
C. Project Implementation	502	297	799	0	66	11	11	11	11	110	909
Equipment and Materials	55	0	55							0	55
Consultancy	447	297	744							0	744
Operating Costs	0	0	0		66	11	11	11	11	110	110
Interest Charge During Implementation	129		129								129
Total	6,699	1,318	8,017	0	1,388	859	1,087	918	763	5,015	13,032

Source: Staff estimates.

**Table A5.3: Yearly Financing Plan by Asian Development Bank And Federated States of Micronesia Government**

Item	ADB Financing Plan					FSM Government Financing					Total
	2002	2003	2004	2005	Subtotal	2002	2003	2004	2005	Subtotal	
A. Secured Transactions Systems	144	0	0	0	144	45	45	45	45	180	325
1. Consulting Services	121				121						121
2. Equipment and Materials	23				23						23
3. Operating Costs					0	45	45	45	45	180	180
B. Institutional Capacity Building	4,079	2,250	615	0	6,945	1,317	1,145	1,145	1,118	4,724	11,669
B.1 Land Administration and Management	1,971	1,354	348	0	3,673	651	480	480	480	2,090	5,763
1. Consulting Services	504	507	348	0	1,359						1,359
2. Equipment and Materials	614	847	0	0	1,461						1,461
3. Operating Costs					0	651	480	480	480	2,090	2,090
4. Civil Works	853				853						853
B.2 FSMDB Services to Start Up and Small Business	423	224	0	0	647	28	28	28	0	83	729
1. Consulting Services	368	224	0	0	592						592
2. Equipment and Materials	55				55						55
3. Operating Costs					0	28	28	28	0	83	83
B.3 Small Business Development Centers	1,685	672	267	0	2,625	638	638	638	638	2,552	5,177
1. Consulting Services	129	377	267	0	772						772
2. Equipment and Materials	215	296	0	0	510						510
3. Operating Costs					0	638	638	638	638	2,552	2,552
4. Civil Works	1,342				1,342						1,342
C. Project Implementation Support	351	187	187	73	799	28	28	28	28	110	909
1. Consulting Services	296	187	187	73	744						744
2. Equipment and Materials	55				55						55
3. Operating Costs					0	28	28	28	28	110	110
Subtotal	4,575	2,437	803	73	7,888	1,389	1,218	1,218	1,190	5,015	12,903
Interest Charge	129				129						129
<b>Total</b>	<b>4,704</b>	<b>2,437</b>	<b>803</b>	<b>73</b>	<b>8,017</b>	<b>1,389</b>	<b>1,218</b>	<b>1,218</b>	<b>1,190</b>	<b>5,015</b>	<b>13,032</b>

FSMDB = Federated States of Micronesia Development Bank.

Source: Staff estimates.

**Table A5.4: Disbursement by Year**  
(\$'000)

Items of Components	2002	2003	2004	2005	Total
A. Secured Transactions Systems	190	45	45	45	325
1. Consulting Services	121	0	0	0	121
2. Equipment and Materials	23	0	0	0	23
3. Operating Costs	45	45	45	45	180
B. Institutional Capacity Building	4,054	4,737	1,760	1,118	11,669
B.1. Land Administration and Management	2,622	1,834	828	480	5,763
1. Consulting Services	504	507	348	0	1,359
2. Equipment and Materials	1,467	847	0	0	2,314
3. Operating Costs	651	480	480	480	2,090
B.2.FSMDB Services to Start Up and Small Business	451	251	28	0	729
1. Consulting Services	368	224	0	0	592
2. Equipment and Materials	55	0	0	0	55
3. Operating Costs	28	28	28	0	83
B.3. Small Business Development Centers	981	2,652	905	638	5,177
1. Consulting Services	129	377	267	0	772
2. Equipment and Materials	215	1,638	0	0	1,852
3. Operating Costs	638	638	638	638	2,552
C. Project Implementation Support	379	215	215	101	909
1. Consulting Services	296	187	187	73	744
2. Equipment and Materials	55	0	0	0	55
3. Operating Costs	28	28	28	28	110
Subtotal	4,622	4,997	2,020	1,263	12,903
Interest Charge	23	48	35	23	129
<b>Total</b>	<b>4,645</b>	<b>5,045</b>	<b>2,056</b>	<b>1,286</b>	<b>13,032</b>

FSMDB = Federated States of Micronesia Development Bank.

Source: Staff estimates

**Table A5.5: Private Sector Development Program Loans/Cost Allocation Among the National  
and State Governments**  
(\$'000)

<b>Project Loan</b>	<b>National</b>	<b>Yap</b>	<b>Chuuk</b>	<b>Kosrae</b>	<b>Pohnpei</b>	<b>Total</b>
A. Secured Transaction Center	29	29	29	29	29	144
B. Institutional Capacity Building	2,119	1,100	1,677	1,158	891	6,945
B.1 Land Administration and Management	1,002	825	925	750	170	3,673
B.2 FSMDB Strengthening	647	0	0	0	0	647
B.3 Small Business Development Center	470	275	751	408	721	2,625
C. Project Implementation Support	501	74	74	74	74	799
D. Interest Charge During Implementation	129					129
Subtotal (A+B+C+D)	2,779	1,204	1,780	1,261	994	8,017
<b>Program Loan</b>	<b>1,000</b>	<b>800</b>	<b>1,300</b>	<b>800</b>	<b>1,100</b>	<b>5,000</b>
<b>Total</b>	<b>3,779</b>	<b>2,004</b>	<b>3,080</b>	<b>2,061</b>	<b>2,094</b>	<b>13,017</b>

FSMDB = Federated States of Micronesia Development Bank.  
Source: Staff estimates.



**Table A5.6: Project Cost Estimates by State**  
(\$'000)

	National Government			Yap			Chuuk			Kosrae			Pohnpei			Whole Project		
	FC	LC	Total	FC	LC	Total	FC	LC	Total	FC	LC	Total	FC	LC	Total	FC	LC	Total
<b>A. Base Cost</b>																		
1. Civil Works	0	0	0	289	96	385	578	193	770	388	129	517	392	131	523	1,646	549	2,195
a. Secured Transaction Center	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
b. Capacity Building	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
b1 Land Administration & Mngmnt	0	0	0	206.25	69	275	206.25	69	275	206.25	69	275	20.625	7	28	639	213	853
b2 FSMDB Strengthening	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
b3 Small Business Devt Center	0	0	0	82.5	28	110	371.25	124	495	181.5	61	242	371.25	124	495	1,007	336	1,342
c. Project Implementation Unit	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2. Equipment and Materials	115	0	115	570	0	570	701	0	701	526	0	526	193	0	193	2,105	0	2,105
a. Secured Transaction Center	5	0	5	5	0	5	5	0	5	5	0	5	5	0	5	23	0	23
b. Capacity Building	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
b1 Land Administration & Mngmnt	0	0	0	461	0	461	561	0	561	386	0	386	53	0	53	1,461	0	1,461
b2 FSMDB Strengthening	55	0	55	0	0	0	0	0	0	0	0	0	0	0	0	55	0	55
b3 Small Business Devt Center	0	0	0	105	0	105	135	0	135	135	0	135	135	0	135	510	0	510
c. Project Implementation Unit	55	0	55	0	0	0	0	0	0	0	0	0	0	0	0	55	0	55
3. Consulting Services	2005	0	2,535	190	0	248	243	0	309	164	0	218	217	0	279	2,820	0	3,589
a. Secured Transaction Center	20	4	24	20	4	24	20	4	24	20	4	24	20	4	24	99	22	121
b. Capacity Building	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
b1 Land Administration & Mngmnt	824	178	1,002	73	16	89	73	16	89	73	16	89	73	16	89	1,118	242	1,359
b2 FSMDB Strengthening	485	107	592	0	0	0	0	0	0	0	0	0	0	0	0	485	107	592
b3 Small Business Devt Center	408	62	470	53	8	60	105	16	121	26	4	30	79	12	91	671	101	772
c. Project Implementation Unit	268	178	446	45	30	74	45	30	74	45	30	74	45	30	74	447	297	744
4. Interest Charge During Implementation	129	0	129	0	0	0	0	0	0	0	0	0	0	0	0	129	0	129
<b>Subtotal (A)</b>	<b>2,249</b>	<b>530</b>	<b>2,779</b>	<b>1,049</b>	<b>154</b>	<b>1,204</b>	<b>1,522</b>	<b>258</b>	<b>1,780</b>	<b>1,078</b>	<b>183</b>	<b>1,261</b>	<b>801</b>	<b>193</b>	<b>994</b>	<b>6,699</b>	<b>1318</b>	<b>8,017</b>
<b>B. Operating Costs</b>																		
1. Secured Transaction Center	0	75	75	0	26	26	0	26	26	0	26	26	0	26	26	0	180	180
2. Capacity Building	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
2a Land Administration & Mngmnt	0	171	171	0	454	454	0	615	615	0	557	557	0	292	292	0	2090	2,090
2b FSMDB Strengthening	0	20	20	0	16	16	0	16	16	0	16	16	0	16	16	0	83	83
3. Small Business Devt Center	0	1,056	1,056	0	352	352	0	418	418	0	308	308	0	418	418	0	2552	2,552
4. Project Implementation Unit	0	66	66	0	11	11	0	11	11	0	11	11	0	11	11	0	110	110
<b>Subtotal (B)</b>	<b>0</b>	<b>1,388</b>	<b>1,388</b>	<b>0</b>	<b>859</b>	<b>859</b>	<b>0</b>	<b>1,087</b>	<b>1,087</b>	<b>0</b>	<b>918</b>	<b>918</b>	<b>0</b>	<b>763</b>	<b>763</b>	<b>0</b>	<b>5015</b>	<b>5,015</b>
<b>Total</b>	<b>2,249</b>	<b>1,918</b>	<b>4,167</b>	<b>1,049</b>	<b>1,013</b>	<b>2,063</b>	<b>1,522</b>	<b>1,345</b>	<b>2,866</b>	<b>1,078</b>	<b>1,102</b>	<b>2,179</b>	<b>801</b>	<b>955</b>	<b>1,757</b>	<b>6,699</b>	<b>6,333</b>	<b>13,032</b>

FC= foreign currency, FSMDB= Federated States of Micronesia Development Bank, LC= local currency.

Source: Staff estimates.

## ENVIRONMENTAL IMPACT ASSESSMENT

### A. POLICY LOAN

Policy Measure	Assessed Environmental Impact
Maintain financial stability.	? Limited government budgets may have an indirect impact on expanding the surveillance, monitoring, and control functions of the state environmental protection agencies and similar development review agencies. However, in most cases this can be resolved by more efficient use of existing resources.
Increase the commitment to the future financial stability of the Federated States of Micronesia by increasing savings and investment in the FSM Trust Fund.	? The FSM Trust Fund measures are unlikely to directly affect the environment. Indirectly, assured future funding will guarantee funding for environmental protection, provided the institutional issues surrounding these agencies can be addressed.
Maintain a low and sustainable level of net external debt to allow for the uncertainties over Compact renegotiations and future debt service capacity.	+ Past external debt was used to finance unsustainable government operations including public enterprises. Avoidance of unsustainable government enterprises will reduce the possibility of inefficient exploitation of FSM's natural resources.
Limit size of government by avoiding a net increase in public service payrolls.	? Reexpanding the staff of surveillance, monitoring, and control functions of the state environmental protection agencies and similar development review agencies may have an indirect impact. However, their prelayoff performance raises institutional issues over the most appropriate means of fulfilling this function in the future.
Initiate a program of public enterprise divestment and privatization.	+ Public enterprise reform in general is expected to facilitate investment in more efficient production, especially ocean fisheries. However, this may also lead to larger catches. To control the use of the fisheries resource, the FSM is developing a comprehensive marine resource management plan.
Encourage long-term investment and commitments through long-term land lease.	+ Long-term land leasing laws are intended to attract more sustainable investments in shore facilities supporting the fisheries industry, tourism, and agriculture leading to environmental improvement. This will help decrease the cases of short-term resource exploitation that has proven to be environmentally damaging.
Facilitate the use of land leasehold mortgage to increase availability of finance for private sector development.	+ Leasehold mortgaging is expected to increase the interest of both borrower and lender in ensuring the longer-term sustainability of the enterprise, benefiting the environment.
Encourage foreign investment in competitive export growth industries by streamlining and improving transparency in foreign investment laws and regulations.	- Increased foreign investment may increase the pressure on resource use in the FSM, negatively impacting the environment. However, by establishing open and transparent laws and regulations on resource use, and increasing the attractiveness to quality and longer-term investors capable of sustainably developing the FSM's areas of comparative advantage, this is expected to reduce the number of short-term opportunistic ventures. Predetermine of which subsectors investment will occur in is uncertain, but tourism, fisheries, light manufacturing, and to a lesser extent, agriculture are the most likely.

**B. INVESTMENT PROJECT**

Project Component	Assessed Environmental Impact
Encourage lending for commercial start-ups and expansion through secured transactions legislation.	? Commercial activity resulting from additional small loans will increase production. Predetermining in which subsectors production growth will occur is difficult, but for small loans this is likely to include marketing and retailing, handicrafts, inshore fisheries, and agriculture. The impact on natural resources and the environment will depend on the method of production and the enforcement of sustainable production methods.
Encourage long-term investment through settlement of land disputes, accelerated adjudication, determination, titling, and improved record keeping.	+ Clear land ownership and property rights are expected to increase the incentive to use land resources more sustainably. This includes both individually owned land and communal lands and has been clearly demonstrated through the Pohnpei Watershed Management Project.
Develop competitive land markets through improved land valuation.	+ Valuation and exchange of land will lead to the development of land for its optimum use, compared with the extensive use of methods currently observed where title is not held or unclear. As valuation will also be done in parallel with the clarification of title, overall land should be used more sustainably. This is expected to be enhanced with improved land use planning.
Improve the capacity of banking services and products to finance private sector growth including small business and business start-ups.	? Commercial activity resulting from additional loans will increase production. Predetermining in which subsectors production growth will occur is difficult, but sectors will include tourism, fisheries, and agriculture. The impact on natural resources and the environment will depend on the method of production and the enforcement of sustainable production methods.
Strengthen business development services to provide information, advice and training for businesses at all levels of experience, including informal and small business.	+ Strengthened business services provide an opportunity to ensure that trainees are also trained in sustainable production methods.
Ensure private sector employment opportunities are known and widely disseminated through improved labor market information.	? The extent to which increased employment will impact on the environment will depend on which sectors will expand as a result of additional investment.

### INELIGIBLE ITEMS

1. The proceeds of the proposed loan may be used to finance the foreign currency expenditures of imported goods (excluding any duties or taxes) required during program implementation. All imported goods financed from the proposed loan must be produce in, and procured from, the member countries of the Asian Development Bank (ADB).

2. Notwithstanding the provisions for paragraph 1 above, no withdrawals may be made for

- (i) expenditures for goods included in the following groups or subgroups of the United Nations Standard International Trade Classifications, Revision 3:

Group	Subgroup	Description of Items
112	-	Alcoholic beverages
121	-	Tobacco, unmanufactured; tobacco refuse
122	-	Tobacco, manufactured (whether or not containing tobacco substitutes)
525	-	Radioactive and associated materials
667	-	Pearls; precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof; fuel elements (cartridges); nonirradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases); goldsmiths' wares or silversmith's wares (including set gems)
971	-	Gold, nonmonetary (excluding gold ores and concentrates)

- (ii) expenditures for goods intended for military or paramilitary purpose or for luxury consumption;
- (iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification;
- (iv) expenditures for goods supplied or to be supplied under any contract that a national or international financing institution or any other financial agency has financed or agreed to finance, including any contract financed or to be financed under any loan ADB; and
- (v) expenditures incurred more than 180 days prior to the date of effectiveness of the loan.

## INDICATIVE CONTRACT PACKAGES

Contract Packages		Estimated Value (\$ '000)	Procurement Method
A.	Secured Transactions	<b>144</b>	
	1. Equipment: Secured Transactions	23	DP
	2. Consulting Services: Secured Transactions	121	CS
B.	Institution Capacity Building		
	1. Land Administration and Management	<b>3,673</b>	
	a. Civil Works: Land Office Construction and Upgrading	853	LCB
	b. Equipment: Land Survey, Mapping, and Registration	1,461	ICB
	c. Consulting Services: Land Administration	1,359	CS
	2. Strengthening of FSMDB	<b>647</b>	
	a. Equipment: FMIS Computer Systems	55	DP
	b. Consulting Services: Strengthening of FSMDB	592	CS
	3. Business Development Centers	<b>2,624</b>	
	a. Civil Works: Business Center Construction	1,342	ICB
	b. Equipment: Business Center Furnishing and Equipping	510	ICB
	c. Consulting Services: Business Center Strengthening	772	CS
C.	Project Implementation Support	<b>799</b>	
	1. Equipment: PIU Computers and Equipment	55	DP
	2. Consulting Services: Program Manager	744	CS

CS = consulting services, DP = direct purchase, FSMDB = Federated States of Micronesia Development Bank, FMIS = financial management information system, IS = international shopping, LCB = local competitive bidding, PPIU = program-project implementation unit.

## Notes:

Consultants for the land administration component (No. B.1.c) are to be engaged as a team from a firm.

Consultants for the FSMDB component (No. B.2.b) are to be engaged as a team from a firm.

## **OUTLINE TERMS OF REFERENCE FOR CONSULTING SERVICES UNDER THE INVESTMENT PROJECT**

### **A. Secured Transactions Systems Development (Component A)**

#### **1. Secured Transaction Legislation.** Tasks include the following:

- (i) Review the draft bill for the Federated States of Micronesia (FSM) secured transactions law and any efforts to implement that law by establishing a registry.
- (ii) Advise on existing field office agreements between the national government and each state government or, if such agreements do not exist, assist in establishing them.
- (iii) Design an electronically based system (the registry) for receiving, inputting, classifying, storing, and retrieving information on financing statements and their assignment, continuation, amendment, and termination.
- (iv) Assist in designating and procuring computer hardware and software necessary for the registry. Hardware for the state field offices, which is to be provided in connection with automation of the state land records under another component of this Project, is expected to be adequate for use with this registry.
- (v) Assist in installing and testing the registry.
- (vi) Train the registrar of corporations and appropriate field office personnel in use of the registry.
- (vii) Recommend protocols for periodic maintenance of registry equipment and backing-up of registry data.
- (viii) Recommend a fee structure for the various kinds of filings with and searches by registry officials, which is reasonably related to the operating costs incurred.

### **B. Institutional Building (Component B)**

#### **1. Land Administration and Management Component**

#### **2. Team Leader/Land Administration Specialist.** Tasks will include the following:

- (i) Help the state governments modify and develop policies and procedures related to land administration and management including that of public lands.
- (ii) Develop transparent, simple, and fair administrative processes and procedures to handle land issues including land leasing and mortgaging, land conveyancing, compulsory acquisition (eminent domain), or voluntary purchase of privately held land. In addition, assist the land registration specialist with adjudication and registration processes and procedures; the survey and mapping specialist with survey and mapping processes and procedures; the valuation specialist with valuation processes and procedures; and the land use planning specialist with land use planning regulations and procedures.
- (iii) Advise the state agencies on overall institutional matters and management practices.
- (iv) Train officials to undertake tasks in the new institutional and administrative environment.
- (v) Advise on and develop privatization strategies for, initially, Pohnpei State Survey and Mapping Section, Division of Lands, and Department of Resource

Management and Development; and assess potential for privatization of survey and mapping functions in the other three states.

- (vi) Develop and introduce changes in personnel management and organization.
- (vii) Advise on and develop appropriate user fee policies.
- (viii) Advise on and develop methods for the introduction of incentives to use the registration system.
- (ix) Assist the state coordination committees in managing and coordinating the land component implementation.
- (x) Help promote public awareness of the benefits from the improved services.
- (xi) Provide other assistance as necessary to improve the management of land administration records.

3. **Land Registration Specialist.** Responsibilities will include the following:

- (i) Advise state agencies on the following aspects of land registry management: adjudication and first registration procedures; protection of third party rights; notification procedures; procedures for dispute settlement, including administrative systems, and specialized mediation units; rectification; indemnity and judicial powers.
- (ii) Design and develop improved and simplified administrative and operational procedures in liaison with the survey and mapping specialist and the systems analyst.
- (iii) Train personnel to undertake tasks in the new administrative environment.
- (iv) Liaise with the survey and mapping specialist and the systems analyst on the following issues: accuracy of information; copyright of information; and security of information and the protection of the database.
- (v) Assist the systems train personnel in the use of the automated system to be developed by the systems analyst.
- (vi) Liaise with the lawyer on amending legislation and regulations as necessary.
- (vii) Provide other assistance as necessary to improve the management of land administration records.

4. **Survey and Mapping Specialist.** Scope of work includes the following:

- (i) Assist the state agencies in preparing specifications for carrying out digital surveys and producing digital cadastral plans and index maps, and develop digital production flowlines for title mapping at the necessary scales in liaison with the systems analyst.
- (ii) Train personnel to undertake tasks in the new administrative environment.
- (iii) Design and develop new administrative and operational procedures and processes.
- (iv) Design, develop, and implement a training program on the practical use of the equipment to be procured under the land component; survey theory.
- (v) Assist the board of surveyors prepare a written examination for the end of the training program leading to the licensing of the surveyors.
- (vi) Liaise with the land registration specialist and the systems analyst to ensure the effective integration of the digital survey and mapping system with the automated registration system.
- (vii) Design and develop procedures for database management and quality control.
- (viii) Identify ongoing training requirements as necessary and appropriate.
- (ix) Work with supplier representatives and the system analyst to install and implement the system including assessing plans for operating systems prior to and during

delivery and installation, and ensuring that the appropriate premises are prepared prior to equipment delivery.

- (x) Help with other functions as necessary to ensure the smooth flow of digital survey and mapping to support the registration process.

5. **Systems Analyst and Trainer.** Work will include the following:

- (i) Undertake a systems analysis, in liaison with the land registration and survey and mapping specialists.
- (ii) Prepare conceptual and detailed designs for the land registry and survey and mapping systems.
- (iii) Develop appropriate software and databases for the systems.
- (iv) Install, implement, and test the systems.
- (v) Train personnel in the use of the automated registration system in liaison with the land registration specialist.
- (vi) Train personnel in the use of the digital survey and mapping system, liaising with the survey and mapping specialist as necessary.
- (vii) Identify ongoing information system and technology training requirements.
- (viii) Advise the state agencies on all aspects of system security, management, and maintenance in liaison with the land registration and survey and mapping specialists as necessary and appropriate.

6. **Valuation specialist.** Responsibilities include the following:

- (i) Advise the state agencies on land valuation methodologies, including single property and mass valuation techniques, role of market signals in property valuation, frequency of valuation adjustments, and valuation of different types of land.
- (ii) Specify and develop a methodology to carry out this work.
- (iii) Advise on and develop data management practices for valuation work.
- (iv) Advise on and develop processes and procedures for quality assurance, notification, and appeals; and public access to information for property valuation.
- (v) Advise on methods and approaches to real property insurance.
- (vi) Advise on and develop appropriate arbitration procedures.
- (vii) Develop and run a training course on the valuation methodology developed.

7. **Land Use Planning and Legal Information System Specialist.** Work will include the following:

- (i) Provide Pohnpei Division of Lands with international experience in the area of land use planning.
- (ii) Review existing institutional and organizational issues related to zoning and land use management, and make recommendations as appropriate.
- (iii) Review the existing Land Use Master Plan and associated regulations, and propose revisions and amendments as necessary and appropriate.
- (iv) Develop land information system applications to assist in the implementation and monitoring of the Land Use Master Plan.



8. **Legal Expert.** Responsibilities will include the following:

- (i) Liaise with the team leader, and the rest of the team members to provide assistance and advice to the state agencies and the Attorney General's Office in the amendment of existing legislation and regulations or the drafting of new legislation and regulations as appropriate and necessary, as a consequence of institutional arrangements and administrative procedures and processes.
- (ii) Provide assistance in other areas, as necessary, to improve the legal base of lands administration records management.

**2. Finance Component**

9. **Senior Banking Adviser.** Work will include the following:

- (i) Assist and guide the FSM Development Bank management in developing and disseminating a revised corporate plan for the FSMDB, designed to be proactive in business development, and with clear goals and strategies.
- (ii) Assist and guide senior management to achieve acceptable standards of management skills through on-the-job coaching and targeted training.
- (iii) Support the establishment of the business development program, and in particular the Outreach Program to start-up and small business.
- (iv) Provide training in basic lending principles, understanding loan documents and securities, and loan appraisal and supervision techniques.
- (v) Work with management to review lending policies, procedures, and practices; and introduce changes required to all staff concerned.
- (vi) Monitor the loan appraisal process to ensure a structured approach to appraisal of projects, in keeping with current best practice.
- (vii) Assist with the review of job descriptions in relation to the new corporate plan requirements, performance targets, employee appraisal system, staff skills analysis, and training needs program.
- (viii) Assess arrears management activities, and recommend strategies for improvement.
- (ix) Review the credit risk classification system to ensure that the portfolio is accurately assessed and managed, and that provisions for bad debts are promptly determined and reviewed.
- (x) Evaluate industries that figure prominently in FSMDB's portfolio, and where practical, assist in developing standards and benchmarks against which analysts can compare their loan proposals.
- (xi) Provide ongoing advice and constructive critiques on FSMDB lending policy to the Board and management.
- (xii) Assist with the review of information technology requirements, particularly the provision of necessary and improved management reports.
- (xiii) Provide assistance with the enhancement and promotion of the loan guarantee scheme, if agreed to by the board in the revised corporate plan.

10. **Financial Management Information System Specialist.** The scope of work includes the following:

- (i) Assess the current financial management information system and identify needs for upgrading the system.

- (ii) Design a new system in collaboration with FSMDB staff that meets the needs of improved information sharing and expediting decisions.
- (iii) Support the procurement and installation of required software and hardware in the corporate and branch offices.
- (iv) Train staff in the use of the system.

### **3. Business Services Component**

**11. Senior Small Business Development Adviser and Project Manager.** Tasks include the following:

- (i) Prepare materials, course outlines, and announcements for entrepreneurship and other business management training suitable to the needs of entrepreneurs and specific target groups (women, youth, etc.).
- (ii) Conduct a training of trainers and a business consultancy training for the staff of the small enterprise development centers and cooperating organizations.
- (iii) Guide staff on how to conduct research on constraints faced by entrepreneurs, particularly on aspects pertaining to government regulations and policies.
- (iv) Guide staff on how to conduct marketing studies on business opportunities that are potentially viable in the country.
- (v) Assist in developing an Internet-based resource center for accessing business and technical information linking the four states and other international sources of information.
- (vi) Review and analyze the results of business surveys conducted on the constraints faced by aspiring entrepreneurs and existing enterprises, and recommend measures to address these constraints.
- (vii) Review the policies and regulations affecting small-scale industries, and recommend improvements and possible incentives to indigenous small-scale entrepreneurs, particularly in less developed rural areas and outer islands.
- (viii) Discuss with relevant government agencies, private sector organizations, and individual entrepreneurs; and prepare report(s) to the FSM and state governments embodying observations and recommendations.

**12. Small Business Development Specialists.** Four small business development specialists are required for 36 person-months, commencing in project month one, based in Chuuk, Kosrae, Pohnpei, and Yap. Each specialist will be responsible for strengthening the capacity of the small business development center (SBDC) in the development of entrepreneurship and business management training programs for new and existing entrepreneurs and in assisting in the provision of advisory services to entrepreneurs. More specifically, the specialists will carry out the following tasks:

- (i) Prepare schedules, course outlines and announcements for entrepreneurship and other business management training suitable to the needs of entrepreneurs.
- (ii) Act as training coordinator and resource person for the training programs ensuring that counterpart staff are trained on-the-job.
- (iii) Assist in providing management and technical consulting assistance to training participants and other existing enterprises.
- (iv) Prepare guidelines and organizational procedures for day-to-day activities and coordination with cooperating agencies.

- (v) Conduct research on constraints faced by entrepreneurs, particularly on aspects pertaining to government regulations and policies; and recommend improvements and programs to address the constraints.
- (vi) Conduct marketing studies on business opportunities that are potentially viable in the country.
- (vii) Assist in operating an Internet-based resource center for accessing and disseminating business and technical information.

13. **Adviser in Business and Technical Information.** Required for 3 person-months over two visits commencing in project month 4, the adviser will cover all four states, and be responsible for setting up an appropriate Internet-based business and technical information accessing and dissemination system linking the four SBDCs and the FSM Government with relevant providers of business and technical information. Specific tasks include the following:

- (i) Review the needs of enterprises and potential entrepreneurs/employees for business and technical information.
- (ii) Recommend the appropriate hardware and software necessary to develop an effective business and technical information service in all the states of the FSM.
- (iii) Train the staff in implementing the developed business and technical information service and in updating the system as necessary.
- (iv) Conduct seminars/workshops participated in by relevant public and private sector agencies on the availability and use of the business and technical information services.
- (v) Prepare a manual on the use, accessing, and dissemination of business and technical information.
- (vi) Prepare a report of recommendations to the FSM and state governments.

### **C. Project/Program Management (Component C)**

A program-project manager, required for 24 months, must have extensive experience in the delivery of public services to the private sector. The services will be required 3 months prior to loan effectiveness and for 21 months over program-project implementation following loan approval. Specific activities will include the following:

- (i) Design disbursement, procurement, and recruitment procedures and guidelines under the Program.
- (ii) Prepare state proposal design and procurement guidelines for the investment project component.
- (iii) Prepare guidelines and support the Department of Economic Affairs (DEA) in recruiting consultants under the loan proceeds.
- (iv) Design and activate national and state implementation and performance monitoring and evaluation system including related training of DEA and state counterpart staff.
- (v) Facilitate the establishment and start-up of national and state level steering committees, specifically the business development councils or their equivalent.
- (vi) Assist DEA and national and state steering committees in making widely known the improvements and changes under Program.
- (vii) Train DEA counterpart staff and the state counterpart staff from each agency assigned to manage project implementation.
- (viii) Support the secretary of economic affairs in providing overall direction to consulting services delivered through the investment component.

## IMPLEMENTATION SCHEDULE

	2002	2003	2004	2005	2006
Secured Transactions Law Finalization and Passage					
Registry Installation and Operation					
<b>Land Administration and Management</b>					
Land Administration System Design					
Conceptual and Technical Design of Land Registration System					
Conceptual Design and Technical Design of Survey & Mapping System					
Land Administration System Implementation					
Fielding of International Consulting Services and Training					
Land Administration and Management Advisor Team Leader					
Land Registration Specialist					
Survey and Mapping Specialist					
Systems Designer/Database Specialist					
Valuation Specialist					
Land Use Planning/Legal Information System Specialist					
Lawyer					
Construction or Upgrading of Land Agency Facilities					
Chuuk Land Registry Upgrading					
Kosrae Land Registry Upgrading					
Pohnpei Land Registry Upgrading					
Yap Land Registry Upgrading					
Land Agency Equipment Installation					
Land Commission/Land Tenure Court Offices - Installation of					
Registration, Administration, and Archive Equipment					
Pohnpei Land Tenure Court					
Chuuk Land Commission					
Yap Land Registry					
Kosrae Land Commission					

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Land Divisions, Survey and Mapping Sections - Installation of Equipment  
for Surveys, Map Production, Map Archive Unit, and  
Administration

Chuuk Division of Land Management and Land Commission  
Yap Division of Land Resources  
Kosrae Survey and Mapping Division

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**Federated States of Micronesia Development Bank Services to Start-  
Up**

Fielding of International Consulting Services and Training

Senior Banking Adviser  
Financial Management Information System Installation and Training  
Management Skills  
Customer Service/Marketing

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**Small Business Development Centers**

Fielding of International Consulting Services and Training

Senior Business Development Adviser  
Team Leader  
Small Business Development Advisers (4)  
Labor Market Information Adviser

Construction of Business Development Centers

Kosrae Business Development Center  
Chuuk Business Development Center  
Pohnpei Business Development Center  
Yap Business Center Upgrading

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Fielding of International Program Manager  
Establishment and Operation of the Program-Project Implementation Unit

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## PERFORMANCE MONITORING AND EVALUATION INDICATORS

Components	Indicators	Baseline (September 2001)					Interim targets (April 2003)	Final Targets (April 2005)
I. Program							2nd tranche conditions	Final targets in the policy matrix
<b>A. Economic Reforms</b>								
A.1 Maintenance of Balanced Budgets	Balanced budget on total current revenues and grants less expenditures	N b	Y b	C b	P b	K b	Balanced budget maintained in FY2003 and FY2004	Fiscal position of the five governments is strengthened with level of financial reserves maintained or increased
A.2 Maintenance of Government Payroll	Payroll percentage to the total expenditures	N	Y	C	P	K	Continued maintenance of wage bill restraint with annual increases not exceeding 1.5% in FY2003 and FY2004.	Real wage bill reduced and nonwage operating expenditures enabled to increase as a share of total expenditures
A.3 Sound Management of the Federated States of Micronesia Trust Fund	Net asset value of the FSM Trust Fund	3 million					The 50% of the increase of budgetary support under the Compact Base Grant for FY2002 and FY2003 dedicated to the FSM Trust Fund	Temporary increase in transfers does not inflate recurrent expenditures and increased FSM Trust Fund balance improves long-term sustainability of government services
A.4 Sound Management of External Debt	Ratio of external debt to GDP	24%					Continued maintenance of official debt remains below 4% of GDP in FY2003 and FY2004	FSM external debt position is improved, enabling the nation to safely liberalize its external debt policy after Compact economic assistance provisions are renewed
A.5 Progress in Public Sector Enterprises Reforms	Progress of public enterprises reform	N -	Y -	C -	P -	K -	At least one public enterprise is transformed by each national and state government	Successful transformation of at least five public enterprises provides models for further progress and reduces the role of government in commercial activities

N: National Government  
Y: Yap State  
C: Chuuk State  
P: Pohnpei State

Components	Indicators	Baseline (September 2001)				Interim targets (April 2003)			Final Targets (April 2005)					
B. Legal Reforms														
B.1 Laws Enabling the Improved Use of Land and Property as Loan Security	Number of land leasehold and mortgage transactions	Y	C	P	K									
		0	0	0	0									
B.2 Amendment of Foreign Direct Investment Laws	Number of foreign direct investment cases	N	Y	C	P	K								
II. Project														
A. Secured Transactions System	Number of chattel mortgage filings	Y	C	P	K									
		-	-	-	-									
B. Institutional Building														
B.1 Land Administration and Management	Number of land titles issued Number of Land parcels surveyed and mapped	Y	C	P	K	Y	C	P	K	Y	C	P	K	
		83	200	250	180	350	1500	500	400	1000	5500	2500	1500	
		48	200	228	180	350	1500	500	400	1000	5500	2500	1500	
B.2 Financial Support to SMEs	Number of FSMDB loans below \$50,000 \$10,000 \$ 1,000 Loans to outer island Loans to households headed by women	Y	C	P	K									
		204	5010	50	50									
B.3 Business Development Support	No. of entrepreneurship and management training courses held No. of participants Short-term seminars and workshop No. of participants No. of entrepreneurs advised No. of enterprises started No. of enterprises expanded	Total	Y	C	P	K								
		30												
		600												
		84												
		1,700												
		420												
		150												
200														

FSM = Federated States of Micronesia, FSMDB = FSM Development Bank, GDP = gross domestic product, SME = small and medium enterprise.

**ECONOMIC IMPACT ASSESSMENT:  
SUMMARY OF WITH AND WITHOUT COMPARISON**

<b>Policy Loan</b>		
<b>Policy Measure</b>	<b>Without Compliance</b>	<b>With Compliance</b>
Maintain financial stability.	Backsliding on fiscal discipline may provide short-term popular gains from a reexpansion of government, but would negate medium-and longer-term gains from expenditure control and undermine confidence in the Federated States of Micronesia (FSM) as a private sector economy.	Control of a resurgence of budget deficits will avoid the need for deficit financing at a critical juncture; favorably impact on macroeconomic stability, improve public, business, and investor confidence in the FSM; and improve prospects for economic growth.
Increase the commitment to the future financial stability of the FSM by increasing savings and investment in the FSM Trust Fund.	Spending of surpluses and Compact extension payments in FY2002 and FY2003 would provide short-term popular gains but will risk an unsustainable reexpansion of government.	Control of short-term reexpansion in public spending and improved savings and investment will contribute to the FSM's future financial sustainability and independence.
Maintain a low and sustainable level of net external debt to allow for the uncertainties over Compact renegotiations and future debt service capacity.	An increase in debt without a secure basis for repayment could jeopardize the FSM's future repayment capacity and undermine investor confidence.	Control of a resurgence in unsustainable external debt will assure a sustainable balance of payments situation and raise investor confidence in the FSM.
Limit size of government by avoiding a net increase in public service payrolls.	Continued large government will attract labor away from the private sector and undermine private sector competitiveness.	Improved fiscal management and increased competitively priced labor will be available to the private sector.
Initiate a program of public enterprise divestment and privatization.	Loss-making or inefficient government enterprises will continue to be a drain on limited public resources, and in some cases will continue to compete with the private sector.	Restructuring, private sector management contracts, privatization/divestiture, and liquidation of public enterprises is expected to reduce the government budgetary burden of nonperforming public enterprises, and reduce competition with the private sector.
Encourage long-term investment and commitments through long-term land lease.	Short lease terms will discourage investment in industries with longer payback periods such as tourism.	Increased attractiveness of lease terms to investors will lead to increased land-based investment. Increased investment leads to improved prospects for private sector growth. Rent and income streams will be for landowners.
Facilitate the use of land leasehold mortgage to increase availability of finance for private sector development.	Access to capital will continue to be a major constraint to private sector investment for FSM businesses.	Access to capital for commercial purposes by domestic landowners will be increased, improving the prospects for private sector growth, employment, and incomes.
Encourage foreign investment in competitive export growth industries by streamlining and improving transparency in foreign investment laws and regulations.	Lack of transparency and excessive red tape will continue to discourage potential investors.	Barriers to entry for foreign investors will be reduced, with potential for bringing investment capital and know how.



**Investment Project****Project Component****Without Project****With Project**

Encourage lending for commercial start-ups and expansion through secured transactions legislation.

Access to capital will continue to be a major constraint to start-up and small businesses

Access to capital and small loans will be increased

Encourage long-term investment through settlement of land disputes, accelerated adjudication, determination, titling, and improved record keeping.

Unresolved land disputes and slow issuance of title will discourage productive use of land resources and investment, and limit access to capital.

Mapping and registry offices will be modernized, staff trained, and survey services privatized. Adjudication and determination will be simplified and accelerated. Improved and accelerated titling and collateralization allows access to finance for investment or secured leasing encouraging investment.

Develop competitive land markets through improved land valuation.

Inappropriate land valuation will undermine competitiveness or lead to lost revenue for landowners, and discourage the development of efficient land markets.

Land values and markets are more competitive leading to improved profitability and competitiveness in the private sector.

Improve the capacity of banking services and products for financing private sector growth including small business and business start-ups.

Inadequate development finance will hamper private sector growth.

Ease of access to finance will stimulate private sector activity and growth.

Start-up and small businesses will continue to be unable to access finance limiting small informal and small entrepreneur development.

Prospects for the informal and small business sector will improve.

Strengthen business development services to provide information, advice, and training for businesses at all levels of experience, including informal and small business.

Lack of access to sound and appropriate business advice will limit potential business start-ups or result in a higher degree of business failure undermining private sector development.

Access to sound and appropriate business advisory services and increased business skills will increase business start-ups and existing business performance, and reduce the risks of business failure.

Ensure private sector employment opportunities are known and widely disseminated through improved labor market information.

Ignorance of employment opportunities and available labor will continue.

Increased awareness of job opportunities through the private sector leading to better utilization of the labor force and increased employment.