ASIAN DEVELOPMENT BANK

RRP: FSM 29657

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON A

PROPOSED LOAN

AND

TECHNICAL ASSISTANCE GRANTS

TO THE

FEDERATED STATES OF MICRONESIA

FOR THE

PUBLIC SECTOR REFORM PROGRAM

April 1997

CURRENCY EQUIVALENTS

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

ABBREVIATIONS

CG	:	Consultative Group
DMC	:	Developing Member Country
EEZ	:	Exclusive Economic Zone
EMPAT	:	Economic Management Policy Advisory Team
ERS	:	Early Retirement Scheme
FIAS	:	Foreign Investment Advisory Service of the International Finance Corporation
FSM	:	Federated States of Micronesia
FTE	:	Full-time Equivalent
FY	:	Fiscal Year
GDP	:	Gross Domestic Product
MEDC	:	Micronesian Entrepreneur Development Center
PATS	:	Pohnpei Agricultural and Trade School
PSRP	:	Public Sector Reform Program
TA	:	Technical Assistance
UN	:	United Nations
UNDP	:	United Nations Development Programme
US	:	United States of America

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., FY1997 ends on 30 September 1997.

(ii) In this Report, "$" refers to US dollars.

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FEDERATED STATES OF MICRONESIA
PUBLIC SECTOR REFORM PROGRAM
LOAN AND PROGRAM SUMMARY

Borrower	:	Federated States of Micronesia (FSM)
Classification	:	Primary Objective: Economic Growth
Rationale	:	The FSM faces an uncertain future. The financial provisions in the 15-year Compact of Free Association, which end in 2001, were aimed at enabling the country to become economically more independent. The high level of annual transfers, however, has distorted the economy, which has become burdened with a large public service and a small productive sector. The FSM is embarking on an economic reform program to facilitate the transformation of the economy as the possible end to Compact funding approaches. The Public Sector Reform Program (PSRP) comprises both immediate adjustment measures to address current reductions in Compact funding, and medium-term measures designed to foster transformation of the economy.
Objective and Scope	:	The overall objective of the PSRP is to reform and reduce the size of the public sector and to shift the balance of economic activity away from the public sector to the private sector. To achieve this, the PSRP has five components: (i) reduce the size and operating costs of the civil service, (ii) increase domestic revenue generation, (iii) restructure government operations and public enterprises, (iv) mitigate the social and economic impact of such public expenditure adjustment, and (v) foster development of the private sector.
Loan Amount and Terms	:	Equivalent to $18 million from the Bank's Special Funds resources. It will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.
Utilization of Loan Proceeds	:	The proceeds of the loan are expected to be disbursed to the FSM through the National Government by March 1998 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 proceeds of the loan. The counterpart funds will be used by the FSM and its component States to support implementation of the PSRP. Appropriate arrangements will be made between the National and State governments to ensure that funds allocated to the

States are disbursed following compliance with conditions included in their respective reform programs.

Tranching : The proposed loan will be released in two tranches. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released in March 1998 subject to compliance with the conditions for release.

Executing Agency : Department of Finance in the National Government

Program Period : November 1995 - 31 March 1999

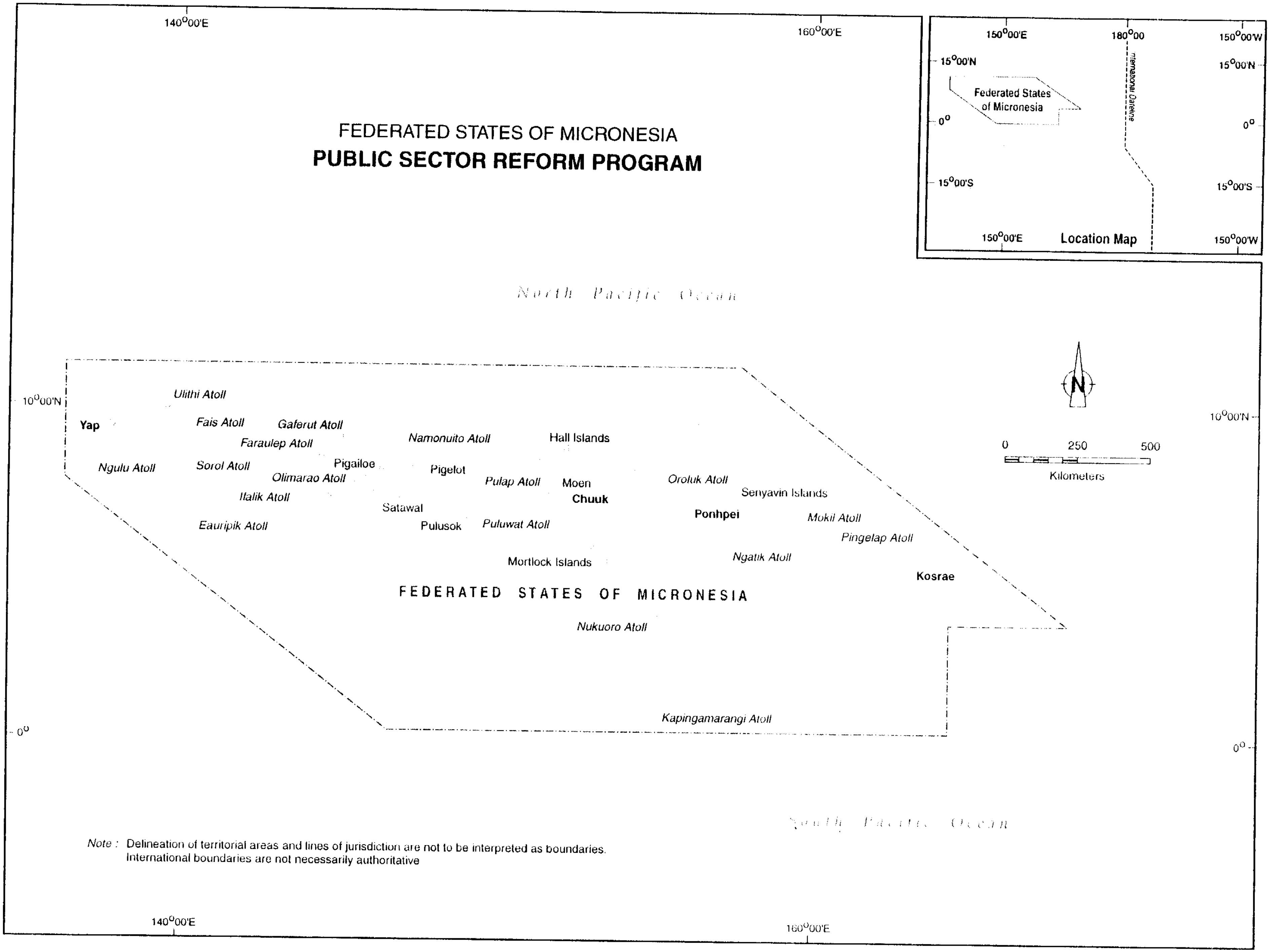
Program Impact : The reform program, which commenced in November 1995, aims to achieve a major transition of the FSM economy to one that is more self-reliant and less dependent on inflows of official transfers. The size of the public sector will be reduced, and the balance of economic activity and the engine for growth will shift to the private sector. By initiating such adjustments now, the National and State governments seek to manage this transition rather than have events eventually force them to take action. Adjustment is inevitable, but its timing and nature can be influenced by planning and facilitation. The loan will support the far-reaching reforms upon which the governments are embarking, underpin revenue growth and the reduction of public expenditure so as to foster more sustainable fiscal operations, help mitigate the initial impact of civil service retrenchment and fiscal adjustments, and help eliminate many of the barriers and distortions that currently inhibit the growth of private investment and initiative.

Program Risks : Three major risks are associated with the PSRP: a possible lack of expertise and institutional capacity to effectively implement the reform program, a possible lack of political will to implement the PSRP fully, and failure of the private sector to develop as envisaged. The FSM has limited skills in economic and policy management, and the ongoing Bank-financed Economic Management Policy Advisory Team (EMPAT) project, together with the proposed augmentation of resources and training of staff, will be critical in assisting the governments in implementing the PSRP, particularly at the State level. The United Nations Development Programme (UNDP) is also providing assistance at the State level. As a result of nationwide economic summits held as part of the PSRP process, there is wide appreciation among political, cultural, and business leaders, as well as within society generally, that change has to occur. However, the inevitable personal dimensions of implementing reforms in small communities, may weaken the present strong political

commitment to implement the PSRP, or prevent target dates from being met. Such risks will be reduced by basing retrenchment largely on voluntary retirement schemes.

Similar risks of delays or noncompliance could arise with respect to reforms to the tax system or to government-owned entities, particularly if the private sector fails to develop fast enough to take up the slack left by the downsized public sector. Over recent decades, the ease of access to Compact funds, and to the imports such funds have financed, has weakened local initiative; encouraged growth of the public sector; and crowded out potential producers of tradable goods and services, or rendered their products uncompetitive internationally. There is therefore a risk that private sector expansion will remain limited. However, the FSM has enormous fishing potential and substantial agricultural and tourism potential, and has some experience in exploiting them. Substantial growth will be feasible if current policy distortions are removed, appropriate training courses introduced, and the governments adopt a promotional rather than an interventionist role.

Technical Assistance : Two technical assistance (TA) grants will be provided to support implementation of the PSRP in two specific areas: (i) a TA of $540,000 to supplement TA No. 2294-FSM, Policy Advisory Team for Economic Management, to augment the resources of the team to assist in direct implementation of PSRP reforms at the State level and increase government capacity to monitor the social and economic impact of the reform program; and (ii) a TA of $380,000 to provide assistance in developing an investment promotion plan and conducting a review of financial sector institutions and instruments with a view to fostering development of the private sector. Consultants will be engaged in accordance with the Bank's *Guidelines on the Use of Consultants*. The Bank's program of assistance to the FSM includes separate TAs to support private sector-led development in the agriculture, fisheries, and tourism sectors.



Note : Delineation of territorial areas and lines of jurisdiction are not to be interpreted as boundaries. International boundaries are not necessarily authoritative

97-0756 HR

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on (i) a proposed loan to the Federated States of Micronesia (FSM) for the Public Sector Reform Program (PSRP); and (ii) proposed supplementary technical assistance (TA) for TA No. 2294-FSM to augment the resources of the Economic Management Policy Advisory Team (EMPAT) to assist in the implementation of the reform program. The Report also describes proposed TA for investment promotion and financial sector review, and if the proposed loan is approved by the Board, I, acting under the authority delegated to me by the Board, shall approve such technical assistance.

II. INTRODUCTION

A. Historical and Political Context

2. The FSM is a confederation of four States. It is part of an extensive group of islands known as Micronesia, scattered over more than seven million square kilometers of the northwest Pacific. Micronesia comprises three archipelagoes : the Caroline islands (comprising FSM and Palau), the Marianas (Guam and the Northern Marianas, including Saipan and Tinian), and the Marshall Islands. The inhabitants of neighboring Kiribati and Nauru are ethnically Micronesian, and those countries are often considered part of the Micronesian region.

3. The FSM consists of the four States of Chuuk (formerly Truuk), Kosrae, Pohnpei, and Yap and covers over 600 islands spread across three million square kilometers of ocean, stretching 2,900 kilometers from east to west. The 370-kilometer (i.e., 200-mile) Exclusive Economic Zone (EEZ) covers 3.1 million square kilometers. The total land area is about 700 square kilometers, with Pohnpei comprising almost half, and the rest equally divided among the other three States. Most of the islands are high and of volcanic origin, with good soils, abundant water, and lush vegetation, although Yap and Chuuk also include low coral islands.

4. The population of 105,500 has eight major indigenous languages, and no two States have the same native tongue, English being used as the common language. Each State has its own culture and character. Pohnpei State, which is also the seat of the National Government, has a population of 33,700; Chuuk, 53,300; Yap, 11,200; and Kosrae, 7,300 (see Appendix 1 for a brief description of each State).

5. The FSM is a new and relatively loose confederation of States, with the States strongly maintaining their individual identities and having significant autonomy over much of their affairs including a high degree of fiscal autonomy. Following World War II, the United Nations (UN) established the Trust Territory of the Pacific Islands, to be administered by the United States and comprising six districts: Chuuk; Pohnpei (including Kosrae, which became a separate district in 1977); Yap; the Marshall Islands; Palau; and the Northern Marianas. In January 1978 the Northern Marianas opted for US Commonwealth status and in July 1978 the others voted on a common constitution. The Marshall Islands and Palau rejected this together with the concept of a single unified Micronesian nation, and went on to establish separate political nations, while Chuuk, Kosrae, Pohnpei, and Yap, became the FSM. The new FSM constitution took effect on 10 May 1979 and, after negotiations with the US, the two countries signed the Compact of Free Association (the Compact) in 1982; this was approved by FSM

voters in a 1983 plebiscite and was officially implemented in November 1986. The UN trusteeship was officially terminated only in December 1990.

6. The FSM government system is based on the US structure. Each State has its own constitution, which determines the balance of power among the three branches of government (executive, legislative, and judicial) and the levels of government (national, state, and municipal). The FSM National Congress is unicameral, with 14 senators: each State elects one senator at large (from among whom Congress elects the president and vice president), and ten based on population (five from Chuuk, three from Pohnpei, one each from Kosrae and Yap). Each State has a governor elected by popular vote, an elected legislature, and a State court. Chuuk State is bicameral. At the municipal level the traditional leaders play an active role in government.

7. Until the 1960s there was little economic or social development, but development expenditure increased in the early 1960s, and a number of US social welfare programs were introduced. These included feeding programs, school meals, sports programs, community support, programs for the aging, and youth employment; however they were introduced with little adaptation to local conditions. The FSM had been self-sufficient in food, but wide distribution of free food led to a rapid decline in local food production. The government administration was top-heavy and focused on financial management; little attention was given to development planning and training.

8. FSM is a new nation, but efforts to create a unified country from the four States with a clear vision of what national unity and economic development mean for each individual State and for the nation as a whole remain somewhat elusive. The States are now seeking an increasing say in decisions affecting the nation's future, particularly as the country looks to the end of the Compact and beyond.

B. The Compact of Free Association

9. Since the effectivity of the Compact in 1986, the FSM has been receiving considerable economic and technical assistance from the US, supplemented by federal grants and additional appropriations by the US Congress. While containing specific provisions on the relations between the two governments in various areas such as foreign affairs, immigration, defense, and environmental protection, the Compact revolves principally around economic assistance (both grant and program assistance), with a number of provisions regarding trade, taxation, and immigration.

10. Under the terms of the Compact agreement, the US pledged to provide grant financial assistance to the FSM for a period of 15 years, ending in October 2001. The largest single element of the grant assistance is the base (or block) grant: $60 million per year for the first five-year period (FY1987-FY1991); $51 million per year for the second five-year period (FY1992-FY1996); and $41 million per year for the third five-year period (FY1997-FY2001). These quinquennial reductions in the base grant have become known as the "stepdowns." In addition, an annual inflation adjustment is made; this currently amounts to about 50 percent of the annual base grant payments. The base grants are paid to the National Government of FSM by the US Treasury and are then allocated among the States according to a formula based largely on population size but modified in favor of the smaller States: Chuuk,

37.4 percent; Pohnpei, 24.3 percent; Yap, 15.5 percent; Kosrae, 10.3 percent; and the National Government, 12.5 percent.

11. The mainly unconditional inflow of money from the Compact has led to major imbalances in the economy. By providing finance for government recurrent expenditure, it lessened pressure for fiscal discipline. By financing an external deficit, it encouraged reliance on imports and lessened pressures to develop new exports. By supporting wage levels that were inconsistent with levels of productivity, it kept costs of production higher than they otherwise would be, and worked against the development of new productive activities.

III. BACKGROUND

A. Recent Economic Performance

1. Overview

12. The FSM has a dual economy similar to the economies of most of its Pacific Island neighbors, with a small modern sector concentrated in the urban districts of the main islands, and a traditional sector prevalent in rural areas and remote islands. The modern, monetized sector is dominated by the public sector and is fueled largely by the inflow of dollars from the Compact. The traditional sector relies largely upon subsistence activities in agriculture and fisheries.

13. Nonmarket production, estimated at 35 percent of gross domestic product (GDP) in 1986, decreased to 21 percent by 1995 largely due to the expansion of the monetized economy since the start of the Compact. The structure of GDP indicates a significant transition. Nonmarket production and public sector employment, which together had represented over two thirds of GDP in 1987, represented just one half by 1995. Both private employee compensation and operating surpluses (including rental income) have grown significantly and now represent the other half of the economy.

14. Real output growth during the Compact period has been disappointing. Given the structure of the Compact, with large stepdowns after the fifth and tenth years, rapid growth rates would have been difficult to achieve. These periodic reductions are in macroeconomic terms the equivalent of negative external shocks. Though expected and planned for, they are still not dissimilar in effect to a permanent terms-of-trade deterioration of approximately 8 percent of GDP in both FY1992 and FY1997. The average annual transfers from FY1987 to FY1991 were reduced over the FY1992-FY1996 period by $15.7 million and will be reduced by a similar amount for the period FY1997-FY2001. This is equivalent to nearly 8 percent of GDP in FY1995. Despite absorbing this negative shock, real GDP grew at an average annual rate of 2.0 percent from FY1987 to FY1995; however, this lagged behind population growth. Real GDP per capita growth was positive in only FY1990 and FY1991. Real GDP per capita, measured in 1995 US dollars, decreased slightly from $1,910 in FY1987 to $1,896 in FY1995.

15. The most immediate macroeconomic management concerns are the maintenance of fiscal balance and the reduction of the large external deficit. Government expenditures accounted for approximately 80 percent of GDP in FY1995. At the consolidated government level, fiscal surpluses through FY1990 were followed by a series of deficits in

FY1991-FY1993, reaching a high of 2.4 percent of GDP in FY1992. Since FY1993, deficit spending has been curtailed at a consolidated level. The external imbalance is characterized by a large trade deficit and a widening deficit in services, both of which are financed by official transfers. External debt, however, is very small.

2. Agriculture and Fisheries

16. Agriculture is the most important activity in the FSM in view of its significance to subsistence employment, wage income, and export earnings. Almost all households are engaged in agricultural activity, even where part of the household is involved in full-time paid employment elsewhere. Agricultural activities provide over 60 percent of the food consumed, and employ about 40 percent of the labor force, full-time or on a seasonal basis. Agricultural processing, however, is relatively limited, although traditional cottage processing of taro and coconut is widespread. Agricultural production and processing have relatively good potential in the FSM, particularly in view of the country's limited resource potential elsewhere, and could be a long-term growth sector.

17. While past development plans have accorded high priority to improving subsistence and semicommercial smallholder production, the Government does not seem to recognize the significant contribution the sector makes to national productivity and to providing food and income to households, nor to its potential for growth. There is a general perception that full-time agricultural employment is neither economical nor desirable and a large portion of the agricultural labor force is moving, or seeking to move, to wage earning employment in nonagricultural activities. There is limited support for the development of essential agriculture infrastructure; credit for production and processing is limited; available agricultural training is not well attended; and research, technology, and extension do not meet the needs of producers. The State and National governments, however, are now focusing on agriculture in developing new Public Sector Investment Plans, but with the emphasis on private sector entrepreneurs.

18. The fisheries resource of the FSM is large, the EEZ covering approximately 3.1 million square kilometers of the Western Pacific Ocean. In common with other Pacific countries, the fisheries sector is essentially dualistic, with the offshore resource, mainly tuna, being exploited by foreign capital, modern technology, and highly capital intensive methods, which contrasts with the inshore fishery, where traditional, low capital, and labor intensive methods of exploitation are practiced. The offshore resource is the major provider of foreign exchange, with annual license fees of $17-21 million over the last four years. The inshore marine resource is one of the most important natural resources to local communities as a provider of food and nutrition, security, and employment.

19. Despite considerable interest and investment in expanding the capacity of the domestic offshore fleet, the resource is largely exploited by distant water fishing nations, which, in 1995, accounted for 98 percent of both the fish catch and the boats involved in the fishery. The extent of operations was significantly reduced in 1996, however, largely because of delays in finalizing bilateral agreements. The National and State governments have been involved in significant investment in fishery capability and in investments designed to process product and service the fleet, either as sole owners or as joint-venture partners. However, recent independent evaluations of these investments, which are in excess of $130 million, have concluded that direct investment in fishing operations has not been successful, and a

number of the ventures are now in receivership. Similarly, the major Government investment in onshore processing, Pohnpei Fisheries Corporation, is also not financially viable.

20. The future for development of the offshore fisheries resource of the FSM as a major driver of economic expansion appears promising. The current level of resource exploitation is thought to be sustainable, with possibly some expansion in the take of certain species. In addition, the market prospects for longline product are strong. The right policy environment is needed to attract private sector investment.

3. Tourism

21. Tourism is a small but relatively important contributor to the FSM economy in terms of employment, income, and export earnings, and has significant potential for growth. Visitor numbers in the Asia and Pacific region have been growing rapidly during the early 1990s, averaging in excess of 8 percent annually. The smaller Pacific Island economies, however, are not sharing in the industry wide tourism growth of the region.

22. The FSM tourism industry is essentially in its infancy, with an estimated number of visitor arrivals in 1995 of around 25,000, of whom about 60 percent or 15,000 are estimated to have been tourists. The principal tourism markets are Japan and the US. The total hotel room inventory is estimated at 513 units in 38 establishments, of which 70 percent are in Pohnpei and Chuuk . Just under half of this capacity is rated average to good, but it comprises mostly small establishments of less than 20 rooms, with no superior or deluxe hotel facilities.

23. The organizational structure of the tourism sector is weak and lacking in resourcing and direction. There is a National Tourism Officer and State-supported Visitors Bureau's but resources are minimal, with the result that private sector operators largely undertake their own marketing rather than contribute to any generic promotional program aimed at industry development and expansion. It is critical that the States adopt collaborative strategies to jointly develop the industry for mutual benefit based on a holistic theme for the FSM, with market differentiation to focus on individual States. The key strategies to expand this concept should focus on five key principles: (i) private sector-led expansion, (ii) development of national and State sector development strategies, (iii) focus on a key image to promote the region, (iv) utilizing tourism as a positive driver for environmental conservation and cultural enhancement, and (v) supporting tourism through parallel investments in key areas of public sector infrastructure.

4. Employment

24. The public service plays the major role in providing formal sector employment, accounting for approximately half of total employment, a ratio that is remarkably constant across the four States. The incentives to seek employment in the public sector are very substantial. The 1994 census reported that the median income from employment in the national public service was over three times greater than income from private sector employment and five times greater than income from being self-employed. Wage levels in State governments, however, are significantly lower, although income from this source was still 70 percent greater than income from private sector employment and 2.7 times greater than income from being self-employed. These wage differentials have evolved as a result of the funding structure of the government being separated from the underlying productivity of the

economy, by large-scale flows of external resources. As these flows are reduced and the public service is downsized, incomes will fall substantially. Underlying productivity can be expected to rise only gradually.

25. The wage differential between public and private sector activities has increased over time as a result of the automatic step increases that have applied to public sector wages. It is estimated that in 1995 this produced an increase in average wages of the order of 6 percent, compared with an estimated inflation rate of 4 percent. It is unlikely that this increase in real wages was matched by an improvement in productivity.

26. The population census shows that unemployment is a significant problem but one that varies considerably between States. Chuuk recorded the highest rate of unemployment at 19.9 percent of the labor force, while Yap recorded the lowest at 9.9 percent. The severity of the problem on Chuuk is of particular concern, given that this State accounts for over half of the population of FSM and is faced with the largest fiscal adjustment (see para. 29). Unemployment of males was only 10.7 percent, compared with 27 percent for females. However participation rates were also significantly different, with only 30 percent of working age females in the labor force, compared with 57 percent of males. As a result, the number of unemployed females was just over half of the total number of unemployed persons. Unemployment is remarkedly age based; youth unemployment is a particularly severe problem. Rates of unemployment in the 15-19 aged group are over 50 percent in Kosrae and 40 percent in Chuuk and Pohnpei; 47 percent of all those who were recorded as unemployed were under 25 years of age. Of great concern is the fact that employment expectations for this group have been determined largely by an economic environment that is no longer sustainable. Given that such a large proportion of this age group is currently unable to secure employment, there is clearly potential for considerable dislocation resulting from a major downsizing of the public service.

5. Government Finances and Financial Prospects

27. The nature of financial relations between the National and State governments, and the high degree of fiscal autonomy enjoyed by the States, hinder the development of a consistent national fiscal policy as part of a reform process to address the tightening revenue situation. In addition, the presentation of consolidated fiscal accounts for the country as a whole provides an inaccurate picture of the fiscal positions of the individual governments. In the case of the four States, their fiscal positions are generally weak, and divergences in their relative positions reflect their differing degrees of fiscal discipline. In the case of the National Government, its relatively healthy fiscal position is a reflection of it being able thus far to maintain control over the country's lucrative fishing license income; the relative positions of the five governments could change significantly if fishing license income were shared in ways similar to those in which Compact income and national tax/duty revenue are shared.

28. The National Government has been able to maintain fiscal surpluses in recent years, and substantial surpluses during FY1992-FY1995. Other than in FY1996, when fishing income and non-Compact grants declined, total domestic revenue followed a rising trend during the first half of the 1990s. While this was partly the result of increases in the revenue from both the wages and salaries tax and the gross revenue tax, it was largely the result of increases in fishing license income and from non-Compact grant inflows. However, while domestic revenue increased, current expenditure rose even more rapidly, especially the

expenditure on goods and services and, to a lesser extent, that on wages and salaries. The increase in the former was particularly marked during FY1995, but expenditure on both line items is provisionally estimated to have been held constant during FY1996, largely as a result of the imposition of stricter expenditure controls and a hiring and promotion freeze. Notwithstanding this, fiscal adjustment and a reduction in the size of staff are necessary for the post-Compact period.

29. The fiscal situation of Chuuk State during the first half of the 1990s was of particular concern, with a deficit emerging in FY1992 following the first stepdown in Compact grants, and substantial deficits occurring in FY1993 and FY1994 as expenditure rose in the face of declining revenue. However, high personnel costs and profligate expenditure policies beyond what could be borne by incipient revenue trends — especially the trends in nontax revenue and non-Compact grants — led not only to fiscal deficits *per se* but to the emergence of domestic payments arrears (of $12 million) in FY1994. These increased to $17 million in FY1995, falling to $16 million in FY1996, but remaining at crisis proportions. Chuuk is in most need of a reform program, and indeed has already implemented a 20 percent pay reduction, effective July 1996.

30. Fiscal operations in Kosrae State were managed more conservatively and more prudently than in Chuuk during the first half of the 1990s. Following growing deficits in FY1992 and FY1993 in the wake of the first Compact stepdown, surpluses have been recorded since. Total revenue and grants increased progressively through to FY1994 and, while they have slipped a little since then, they remain buoyant: tax receipts as well as grants showing some increase. On the other hand, total expenditure followed a declining trend over the first half of the 1990s, largely as a result of restraining expenditure on goods and services and reducing capital expenditure. More recently, and certainly since the salary increase awarded to all civil servants in October 1994 (i.e., FY1995), the State Government has been considering ways to react both to the further stepdown in Compact grants in FY1997 and to the possible circumstances that will take place in FY2001.

31. In Pohnpei State, the fiscal situation remains fragile, but it has been managed in such a way as to reduce progressively the significant deficit that emerged with the Compact stepdown of FY1992, and to turn that deficit into a small surplus in FY1995. This turnaround was achieved by squeezing total expenditure in the face of a generally unchanging overall revenue position. However, while total expenditure was restrained, it was accomplished by a sizable reduction in capital expenditure and in spite of significant increases in the wages and salaries bill. Moreover, a deficit emerged again in FY1996 as revenue stagnated and expenditure increased, the latter as a result of an increase in capital expenditure. Subsidies have fallen significantly since FY1992, a trend that is likely to continue with continuing reform of state-owned enterprises and utilities.

32. In Yap State, the fiscal situation is also one of fragility but, while subject to regular deficits, the State is also characterized by cautious fiscal management. However, total revenues generally stagnated during the first half of the 1990s, with both tax and nontax domestic revenue following declining trends and investment income falling quite sharply. Total expenditure, on the other hand, tended to remain largely unchanged, with rises in current expenditure being mostly matched by reductions in capital expenditure. The outturn in FY1996 was not favorable, as both domestic and external revenue declined and expenditure

increased, the latter as the result of rising subsidies and capital expenditure. In an attempt to bring fiscal operations more in line with a deteriorating external resource position, the authorities began to work during 1996 on effecting a marked degree of long-term structural adjustment, and have made major strides in agreeing locally on what is required and on how to achieve it.

33. In summary the fiscal performance of the country as a whole conceals significant variations in the fiscal performance of the five constituent governments. Nevertheless, while all five governments have had as their stated objective the reduction in operating deficits through increasing revenue and reducing expenditure, efforts have been mixed. Increases in tax and nontax revenue have occurred, but the only significant revenue increase has come from fishing license fees, and most governments have been slow to implement measures to raise domestic revenues. Similarly, the governments have also been slow to effect reductions in current expenditure — particularly in wages and salaries and in goods and services — and none made much conscious effort to adjust to the first Compact stepdown in FY1992. Moreover, while many might have initially budgeted for expenditure reductions, increases have occurred later as a result of supplemental provisions. The changes in the external revenue situation in FY1997 (i.e., the stepdown in Compact funds in October 1996) together with those likely in FY2001 are different in scale, and they have forced on the FSM governments markedly different attitudes from those evident hitherto. Fiscal adjustment is now an imperative and cannot be postponed.

6. Financing Fiscal Deficits

34. There are few financing options available to cover the FSM's fiscal deficits: there is no central bank, no separate domestic currency, and no domestic market for government debt. In practice, therefore, deficit financing is limited to the use of accumulated financial assets (subject to certain constitutional restrictions) and to overseas commercial borrowing secured by future Compact payments. Each State Government and the National Government holds three types of accounts: general, special, and capital. Special account funds relate to unspent funds under Compact special programs and cannot be used for other than their earmarked purposes. Capital account funds relate to Compact capital grants and cannot be used to defray current expenditures. Thus surpluses may exist in the special and/or capital accounts, but these cannot be diverted to finance a current budget deficit, thereby giving rise to potential cash flow problems even in the face of there being surplus funds available elsewhere. Moreover surpluses in one State are not used to finance deficits in another, although it would be technically possible for any State to borrow formally from any other State or from the National Government to finance a deficit .

35. Kosrae, Pohnpei, and Yap have had periodic deficits, but modest surpluses remain in their general fund accounts. In the case of Chuuk, however, the deficits have been too large and sustained, and have been "financed" artificially by simply not paying bills. The National Government has accumulated substantial surpluses, mostly from fishing license income, in its general fund. All States and the National Government have accumulated capital fund surpluses, which, with the exception of Yap's, represent sizable amounts, especially in

the case of Chuuk,[1] Pohnpei, and the National Government. These are available only for capital expenditure, although the interest earned goes into the general funds and thus into current expenditure.

7. External Sector and External Debt

36. The FSM has an open economy. Exports in FY1995 are estimated to have been the equivalent of 33 percent of GDP, while imports are estimated at 76 percent of GDP. Despite persistent large trade deficits, there has been a significant restructuring of FSM's trade with the rest of the world. The increase in exports, mostly fish, has been one of the most positive developments in the FSM during the Compact period. Fees for fishing access rights increased markedly from $3.6 million in FY1986 to $21.5 million in FY1995. Tourism receipts, however, leveled off after some initial growth in the early years of the Compact. Overall, exports of goods and nonfactor services in FY1995 equaled 50 percent of GDP, up from 7 percent in FY1986 and 15 percent in FY1990. The merchandise trade deficit, however, grew from $53.9 million in FY1986 to $95 million in FY1995. This was due to the entrenched reliance on imports, which are funded largely by official transfers.

37. The current account deficit, excluding official transfers, was 52 percent of GDP in FY1995, an improvement over the peak of 66 percent in FY1991. The current account balance including official transfers recovered somewhat from the deteriorating trend from FY1987 to FY1993. It remained positive every year except FY1993, when it was in deficit by $2 million (1 percent of GDP).

38. The only form of borrowing that has been undertaken by the States has been foreign borrowing, which has taken the form of the issuance of medium-term notes guaranteed by a pledge against future Compact payments (through to FY2001 only). The largest of these has been undertaken by Yap — the so-called Yap Monetization Scheme, for the purchase of $71 million of government securities — but there has also been borrowing by Chuuk ($10.3 million) and Pohnpei ($23.9 million) to finance fishing ventures. The National Government has not undertaken any borrowing on its own account, but it guaranteed a loan of $39.9 million for the FSM Telecommunications Corporation from the US Department of Rural Electrification Administration. A further $6 million Government-guaranteed debt is still owed by two national fishing ventures.

39. While the FSM's official total outstanding external debt of $120 million FY1995 (about 56 percent of GDP) and debt-service ratio of 17.5 percent may look relatively high, a major part of this relates to the Yap Monetization Scheme, which is secured by realizable stock market investments and managed by reputable international fund managers. Recalculating these amounts to include only the unrealized loss component of the Yap scheme, and thus providing a more realistic guide to the FSM external debt position, indicates that external debt amounts to 35 percent of GDP, and the debt service ratio about 10 percent. Debt-service payments of about $20 million per year are mainly principal and interest payments on the

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[1] In the case of Chuuk, capital transfers from the Compact are complicated by a State constitutional provision that requires 40 percent of all such transfers to be allocated to its municipalities, which, in practice, lack the skills to design or undertake large capital projects. Accordingly, a large proportion of the available capital funds go unspent, which has led to a situation in which Chuuk's capital account currently has a surplus of some $35 million.

medium-term bond issues, all of which will be repaid by FY2001, after which external debt could decline to 15 percent of GDP, with a debt-service ratio of about 2 percent.

B. Short- and Medium-term Prospects and Issues

40. In the short term, economic prospects are dominated by the reduction in Compact payments of 20 percent on 1 October 1996, and in the medium and long term by the likely end of funding under the Compact in October 2001. As noted in Chapter IV, all four States and the National Government have developed strategies and plans for economic reform and development both to address immediate problems and to initiate transformation of the economy to be more self-sustaining. Chuuk and Pohnpei failed to adjust adequately to the last stepdown in FY1992, and finances in both States became precarious. Chuuk implemented a 20 percent pay cut from 25 July 1996, while Pohnpei just approved (12 March 1997) a 20 percent cut and Kosrae (5 March 1997) a 12.5 percent cut. All States and the National Government have frozen wages and have advanced plans to substantially reduce the number of civil servants over the next two years. Successful implementation of the reform programs should generate fiscal surpluses in the period 1997-2001 and it is important that these are saved in order to assist in the subsequent adjustment to the post-Compact period.

41. The restructuring of public service and the reduction in the availability of employment options within the public service will begin a process of realigning incentives towards private sector activities. There is significant potential for private sector activity in agriculture, fisheries and tourism. However, it is critical that the governments in the FSM recognize that sustainable growth in the private sector cannot be achieved through government interventions in commercial activities. Such interventions are likely to have the opposite impact by undermining private sector competitors, driving up costs and distorting incentives. Given the environment, private sector growth will not appear in the form of large-scale initiatives that can immediately replace the income and employment that has been available due to the Compact transfers. Inevitably there will be a period when living standards need to adjust to the new economic realities; however such an adjustment in consumption is likely to be part of the process of realigning incentives towards productive activities.

42. Foreign investment has the potential to support efforts to improve the performance of the private sector; however there is a need for reforms of the regulatory framework and a clearer commitment to supporting the activities of foreign investors. The current system of approval of foreign direct investment divides responsibility between the National and State governments, and approvals are granted on a case-by-case basis. There is a generally ambivalent attitude towards foreign investment. Despite the potential benefits of duty free access to US markets, it seems likely that the bulk of foreign direct investment in the FSM will be motivated by natural resources, particularly in the fisheries and tourism sectors, or to take advantage of relatively small-scale niche opportunities such as the export of fresh produce to Guam. Given the relatively small scale of the likely involvement of foreign investors, it is important to minimize uncertainty and transaction costs such as getting approvals. Uncertainty relates to the general investment climate, the transparency of the approval and regulatory framework, and independence of the judicial system.

43. The shortcomings of the current system for approving and regulating foreign investment have been recognized by the governments, and proposals for reform have been made by the Foreign Investment Advisory Service (FIAS). These proposals include approval

responsibility being delegated largely to the State level, with uniform investment legislation and specific regulations written against a uniform structure. Other aspects are still under review (see para. 60).

44. Another significant issue that affects both domestic and foreign investment is that customary land ownership and traditional means of land transfer are perceived as hindrances to development. In particular, the inability to consolidate small parcels of land for commercial or extensive agricultural use, the inability to utilize land as security for investment, and the difficulty in securing timely transfer and lease rights to land, are identified as major development problems. The constitution expressly includes non-alienation of land in the FSM to any noncitizen or corporation not wholly owned by FSM citizens. In addition, State legislation normally limits the length of land leasehold to 25 years, which is often too short for major investment projects. EMPAT has been helping the governments address these issues and has conducted a detailed review of the current situation and its constraints; further assistance to develop new legislation and procedures is being provided under Bank TA.[1] Pohnpei State has just extended the maximum term of land lease from 25 to 50 years as a first step in addressing the problem.

45. While any economic growth through the development of the productive sectors will be difficult to achieve in the medium term, important steps towards this goal can be made in the coming years, provided the right policy environment is created. Such growth needs to be private sector led. Important policy adjustments and changes will be needed, and many of these are being addressed now under the economic policy reform programs.

IV. THE ECONOMIC POLICY REFORM STRATEGY

A. Overview

46. The Bank hosted the first Consultative Group Meeting for the FSM on 6 December 1995 in Manila. At that meeting, the Government presented a wide-ranging economic policy reform strategy to reform the public sector to adjust to declining external resource transfers and to shift the balance of economic activity away from the public sector to the private sector. Implementing and harmonizing a comprehensive reform program in five individual governments is a particularly complex exercise. The level of development, the status of the economy, and the urgency of reform differ in each of the States and the National Government. This complex situation requires that specific reform strategies be developed for each State and the National Government.

47. In the past there have been many studies and reports on the situation in the FSM. Almost invariably these studies and reports have identified the same structural problems: the overwhelming size of the public sector and the very low level of productive activity. Over the past 18 months the governments of the FSM have taken actions to involve the wider community directly in the policy development process. The process commenced with a National Summit in November 1995, which was followed by Summits in each of the States. Each of these important meetings was open to the public. Individuals and groups were encouraged to express their opinions and concerns in both the plenary and the committee sessions. In each case the meetings were very well attended by a wide cross-section of the

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[1] TA No. 2758-FSM: *Improved Economic Use of Land*, approved on 4 February 1997 for $550,000.

community. The proceedings were also broadcast on radio and television. These meetings have successfully increased public awareness of the situation facing the FSM, and consequently there is a widening acceptance of the need to reform the State and National economies.

48. The direct involvement of the wider community has created a strong degree of community ownership for the strategies developed during the Summits. This has enabled the Governments to pursue actions that, in other circumstances, would have been even more politically difficult to implement. It has also engendered a degree of impatience in the community to the extent that, despite their real efforts to implement the Summit recommendations, all the Governments are being pressured to hasten the reform process. At the Second Consultative Group Meeting held in Manila on 28 October 1996 the FSM delegation outlined some of the achievements of the reform program: these are summarized in the Development Policy Letter included as Appendix 2.

49. Largely as a result of the National and State Summits, government reform efforts are now focused on four main objectives: (i) reducing the size of government, (ii) funding government operations from domestic revenues, (iii) stimulating the private sector, and (iv) ensuring that the economic development is sustainable.

50. The immediate task facing the State governments is adjusting to the October 1996 stepdown in Compact funding. On 1 October 1996, the block grant component of Compact funding was reduced by 21 percent. The direct impact of this reduction cut total revenues by $15.1 million. This has a greater relative impact on the States, where total State revenues will be reduced by an average of 11 percent. Inevitably this means that the States must cut expenditures for personnel. These cuts will involve both reductions in wages and reductions in force. This difficult task is all the more challenging for Chuuk and Pohnpei, both of which also have outstanding domestic arrears to address. Despite these difficulties, each of the Executives in the four States has submitted a balanced budget to their legislatures. In each case they have included significant cuts in expenditure.

B. Objectives and Components

51. Each of the States and the National Government have prepared PSRPs with the assistance of EMPAT and the Bank. The PSRPs comprise both immediate measures to address current reductions in Compact funding, and medium-term adjustment measures and mechanisms designed to foster transformation of the economy. The proposed PSRPs focus on (i) reducing the size and operating costs of government, (ii) increasing domestic revenue generation, (iii) restructuring government operations and public enterprises, (iv) mitigating the social and economic impacts of public expenditure reductions, and (v) supporting development of the private sector. A key element in downsizing the public service is an early retirement scheme (ERS), which is largely voluntary and for which significant financing will be needed for early retirement incentives.

52. The PSRPs for each government are set out in individual policy matrices, which were attached to the Development Policy Letter and which will be used for implementation and monitoring of the PSRP; they have a common format, and for this Report and Recommendation have been consolidated into a single Policy Matrix (Appendix 3), which is

further reflected in the Project Framework (Appendix 4). The Program components are briefly outlined in Table 1.

Table 1: Components of the Public Sector Reform Program

Reduce the Size of Government	
Public Service Downsizing	Establishment of public sector reform working committees or joint task forces Personnel reduction targets Freezes on hiring, reclassification, etc.
Wage and Salary Reduction	Across-the-board pay cuts Freezing of automatic step increases Reduction of annual carryover of overtime benefits. Reduction in overtime payments Wage and salary reductions as budget targets
Other Cost Reduction Measures	Removal of subsidies and transfers
Increase Domestic Revenue Generation	
Import Taxes Wage and Salary tax Business Gross Revenue Tax	Action/legislation at national level to improve administration and collection; development of proposals for longer longer term reform
State Taxes	Review of systems and implementation of measures to increase revenue
User Charges	Increased user fees to cover operating costs of utilities
Other Charges	New revenue measures
Restructure Government Operations and Government Enterprises	
Functional and Financial Review of Government. Departments and Enterprises	Analysis target; legislation
Identification of activities to be eliminated, privatized, or transferred to other service providers	Divestment of noncore activities
Reform of Public Utilities	Utility Authority responsible for tariff setting User-pay utility pricing policies
Reform and Privatization of Enterprises	Divestment
Mitigate of Social and Economic Impacts on Departing Employees and Families	
Early Retirement Scheme	Legislation to establish early retirement scheme Annuities or lump sum payments

Outplacement and Counseling Services	Retraining programs
Training for Redeployment	Skills upgrading
Training for Transition to Private Sector	Outplacement service; training—College of Micronesia (CM); Micronesian Entrepreneur Development Center (MEDC); and Pohnpei Agricultural and Trade School (PATS)
Support Development of the Private Sector	
Investment Climate	Review and revision of foreign investment procedures and regulations Establishment of private sector investment promotion agency
Financing	Improve use of land as collateral for borrowing from banks and commercial lending organizations—requires revisions to land tenure acts and leasehold development acts Increased availability of finance to small entrepreneurs Commercial loan guarantee or similar program for small entrepreneurs
Infrastructure	Development and implementation of public sector investment program to provide key infrastructure needs
Human Resource Development	Revised school curricula with increase emphasis on technical and vocational education. Adult education and training programs in technical and vocational areas State and National postsecondary scholarship programs to support training in relevant vocational and trade skills Increased scholarships in key economic development areas: agriculture, fisheries, and tourism

C. Program Description

1. Reduce the Size of Government

53. A major element in each reform program is downsizing the public sector over the two years of the program (FY1997-FY1999). Each Government has conducted an analysis to determine in which specific activities the public sector should be involved, and which activities should either be divested to the private sector or discontinued altogether. This analysis was based on a review of functions and not of individuals holding the positions. The Governments intend to achieve the reduction in personnel through an ERS, which to the extent possible will be voluntary. Social Security is payable at age 60. The ERS will require significant up-front costs over the next two years for incentives, and this is the major area that the counterpart funds from the Bank loan will finance. The retirees will be compensated for the loss of their Government jobs and to help them adjust to their new lifestyle. The payments will also inject funds into the economy that will soften the impact of the reduction in the public payroll. It is anticipated that while many of the voluntary retirees may be over 55, a considerable number will be younger with the energy initiative, and appropriate education to make a success in the private sector (the public sector has tended to attract the best graduates), and as such the retrenchment will have a positive impact on private sector development. The retirement schemes have been designed to be attractive to staff, and it is hoped that voluntary retirements will be sufficient to meet the workforce reduction targets. If such targets are not met, then it will be necessary to implement a reduction in force program. Inevitably holders of essential positions will be ineligible for the scheme.

54. Each government faces different problems and has therefore developed slightly different retirement schemes. However, all schemes include the following provisions:

(i) The ERS generally will be open to all, but with first priority given to those whose jobs are affected by the reorganization and downsizing; and appropriate procedures will be adopted to ensure that the efficiency of government is maintained, so some positions will be ineligible.

(ii) Procedures will be followed to ensure that the number of retirees and the cost of the ERS is in balance with the number of positions to be retrenched in order that the costs of the scheme remain within available funding, and that it achieves the long-term objective of cost saving.

(iii) Each retiree will be paid a settlement of up to twice his or her annual salary, either as a lump sum or as an annuity.

(iv) Each retiree will be provided with outplacement counseling, and retraining programs will be available for retirees and for those remaining in government.

(v) Retirees under the ERS will not be eligible for re-employment by the government during the Compact period.

(vi) The ERS will be complemented by private sector development programs.

2. Increase Domestic Revenue Generation

55. While the main fiscal adjustment is to be made by reducing public expenditure, particularly in the short term, at the same time an important contribution should be made by an improved and more efficient tax system, particularly since the tax: GDP ratio of about 10 percent is only half or less of those in other Pacific Island Development Member Countries, and since the system has become too complicated for the authorities to operate effectively. While ostensibly a relatively simple tax system, its operation in the FSM is complicated in practice by the exemptions that are allowed to several of the main taxes imposed, by the organizational structure and relationships that exist within States and between National and State authorities, by the lack of harmonization among taxes, and by certain cumbersome assessment and refund procedures.

56. Taxes are collected both by the National Government and the State Governments — about 80 percent of the total amount by the former — with just over half of that collected by the National Government being redistributed to the States from which it was initially collected[1]. The National Government is responsible for collecting income and import taxes, including the Wages and Salaries Tax (about 36 percent of the tax revenue collected by the National Government in 1995), the Gross Revenue Tax (also about 36 percent); import duties (about 22 percent); and fuel tax (about 6 percent). The National Government also collects fishing license fees, currently one third of all domestically raised revenue and thus an increasingly important source of domestic revenue. For their part, the individual States set and collect sales taxes, various user taxes and registration fees, hotel and airport taxes, motor vehicle and boat rental taxes, and fines, which collectively represent some 19 percent of domestic tax revenue and 7 percent of consolidated domestic revenue.

57. The Government of the FSM has yet to decide on the nature and direction of overall tax reform, and this is a major area in which EMPAT is developing proposals. While the nature of the FSM's tax reform is still in the early stages of development, its basic objectives are to (i) generate significantly more revenues in order to contribute to closer fiscal balance in the face of declining Compact and other US inflows; and (ii) improve the domestic investment climate for the private sector, thereby creating jobs so as to absorb retrenched civil servants and to generate greater domestic economic self-reliance. In addition, whatever the tax system introduced, it should be capable of being effectively administered in the circumstances that obtain in FSM, and it should not absorb excessive administration costs. Numerous deficiencies exist in the present tax administration, and many of these are being addressed in advance of the broader tax reform, as simply raising the tax collection ratio from existing taxes will make a measurable contribution to improved fiscal balances.

3. Restructure Government Operations and Government Enterprises

58. As noted in para. 53, the State and National governments have been reviewing the functions of varied departments and enterprises with a view to identifying those activities that should be privatized or transferred to other service providers, and those that can be eliminated altogether. The States have already transferred the major utilities of power, water,

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1 Half the revenue collected from the National Government's taxes is returned to the State where it was collected, other than in the case of fuel tax where 80 percent is returned.

and sanitation to independent utility authorities, which will be run on commercial lines. The utilities will be responsible for price setting and are reviewing tariffs based on user-pay pricing principles. The Bank is providing assistance for such sector reforms through a loan[1] and TA for expansion, refurbishment, and commercialization of water supply and sanitation services in heavily populated areas. Other activities, such as transport, building maintenance, and printing, are likely to be privatized or the services contracted out.

4. Mitigate the Social and Economic Impact on Departing Employees and Families

59. Each government plans to reduce the size of the workforce through an early retirement scheme over the next two years that is largely voluntary, rather than by forced termination in five years time when Compact funding is likely to cease. The incentive and voluntary components of the scheme will help mitigate the socioeconomic impact of reducing the size of government as they will likely attract (i) those who believe they can do well in the private sector and will use the lump-sum payment to help establish themselves: and (ii) those nearer retirement age, who will use the lump sum or annuity payments to ease themselves into retirement. The Governments will provide counselling services to both these categories, and training programs for those planning to enter the private sector. Many such training programs already exist, such as the United Nations Development Programme (UNDP)/International Labor Organization (ILO) funded MEDC, and PATS and the College of Micronesia. In addition, the programs designed to assist the development of the private sector include commercial credit enhancement schemes (see para. 72) which will be available on a priority basis to those taking early retirement.

5. Support Development of the Private Sector

60. As discussed in paras. 41-45, the restructuring of the public service and reduced availability of employment options within the public service will begin a process of realigning incentives towards private sector activities. There is potential for significant private sector activity in agriculture, fisheries and tourism. The Bank has ongoing TA[2] reviewing prospects in both the fisheries and agriculture sectors, and a TA is under preparation for tourism. These TAs will help develop specific action plans for growth in the sectors. However, it is critical that the governments in the FSM recognize that sustainable growth in the private sector cannot be achieved through government interventions in commercial activities. In addition, there is a need for reforms in the regulatory framework and a clearer commitment to supporting the activities of foreign investors. EMPAT is providing an additional consultant to review current State and National legislation and draft new legislation and regulations based on the FIAS proposal. Implementation of this will be assisted by a TA accompanying this loan (see para. 72). Customary land ownership and traditional means of land transfer are perceived as hindrances to investment and development, and as noted in para. 44, the Bank is providing TA to help address this problem.

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[1] Loan No. 1459-FSM(SF): *Water Supply and Sanitation Project*, for $10.6 million, approved on 19 September 1996. TA No. 2646-FSM: Capacity Building for Management and Operation of Water Supply and Sanitation Systems, for $587,000, approved on 19 September 1986.

[2] TA No. 2484-FSM: *Strengthening of Agricultural Support Services*, for $560,000, approved on 19 December 1995; and TA No. 2551-FSM: *National Fisheries Policy*, for $100,000, approved on 29 March 1996.

V. THE PROPOSED BANK ASSISTANCE

A. Objective

61. The objective of the Bank's assistance is to help the National and four State governments in implementing an economic reform program designed to facilitate the transformation of the economy as the possible end to Compact funding approaches. In particular, Bank assistance will support the PSRP, whose objective is to reform and reduce the size of the public sector to adjust to declining external resource transfers, and to shift the balance of economic activity away from the public sector to the private sector.

B. Bank Assistance

1. Amount of Loan and Source of Funds

62. It is proposed that the Bank provide a loan of $18 million equivalent to support the PSRP. It is proposed that the whole amount of $18 million be provided from the Bank's Special Funds resources. The size of the loan is based on the scope and the costs of the policy reforms, the importance and urgency of the reforms, and the state of public finances.

2. Interest, Maturity, and Utilization Period

63. The loan will have a repayment period of 40 years, including a grace period of 10 years, and carry a service charge on the amounts disbursed of 1 percent per annum. The loan is expected to be utilized over a 15-month period, and funds will be released in two tranches: $10 million in the first tranche and $8 million in the second.

3. Implementation Arrangements

64. The Department of Finance in the National Government will be the Executing Agency for the Program and will be responsible for its overall implementation. At the State level, the office of each Governor will be responsible for overseeing implementation of the respective State reform programs. Restructuring committees have already been formed in all governments and have had responsibility for developing the reform programs; they will continue to oversee the programs.

4. Disbursement

65. The proceeds of the loan are expected to be disbursed to the National Government by July 1998 against submission of documentation acceptable to the Bank relating to imports by the Government of a broad range of goods other than those included in a negative list. To be eligible, imports must be produced in and procured from the Bank's member countries. Eligible imports incurred up to 180 days prior to loan effectiveness may be reimbursed from proceeds of the loan. Procurement of goods in excess of $3,000,000 will be undertaken in accordance with the Bank's international competitive bidding procedures, while procurement of goods for $3,000,000 or less will be in accordance with the purchasers' normal procedures; except that commonly traded commodities may be procured on the basis of procedures appropriate to trade and acceptable to the Bank. Accounts for purchases financed

from the loan proceeds will be maintained in accordance with sound accounting principles and consistent with the Bank's requirements for program loans and imprest accounts. Audits thereof will be undertaken in accordance with sound audit standards and consistent with the Bank's requirements for program loans and imprest accounts.

5. Counterpart Funds

66. Counterpart funds generated by the loan will be used by the National and State governments to support the implementation of the reforms set out in the Policy Matrix.[1] 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 (see Appendix 3). Such counterpart funds will be made available to the States as loans, with terms and conditions to be agreed upon between the National and State governments.[2]

67. The States will establish special accounts into which, over the remaining years of Compact funding, they will set aside funds from the savings on salaries and wages from the current reforms. By the end of the Compact period these accounts will have accumulated sufficient funds to repay the National Government the amounts borrowed from the Counterpart Funds. The accounts are viewed as nascent "trust funds," similar in approach to those in place in Kiribati and Tuvalu, and in the longer term may be expanded and used by the State governments to finance (and repay) other public sector investments (e.g., investment in infrastructure).

6. Monitoring and Tranching

68. On a continuing basis the Government and the Bank will review the implementation of the Program, with a joint review being conducted during the fourth quarter of 1997 prior to the release of the second tranche. It is envisaged that the second tranche will be released at the end of the first quarter of 1998, one year after the first tranche, upon the Bank being satisfied that the conditions for its release have been fulfilled. The second tranche could 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 matrices. For the State(s) not meeting the targets, the corresponding amount will be withheld. Subsequently additional releases could be made as the concerned State(s) achieve their targets, provided these are met by March 1999. If a State fails to meet its targets, then this portion of the loan will be canceled. A joint final review will be conducted in the last quarter of 1998.

69. Conditions for the release of the second tranche include a general condition that sufficient progress has been achieved and maintained in carrying out the respective reform programs as set out in the second tranche column of the policy matrices. This includes maintaining constraints on spending introduced under previously approved budgets encompassing, among other things, maintenance of the constraints on the salaries of

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1 The Counterpart Funds tranche releases will ensure funding by each government of the cost of the ERS and related personnel training.

2 The terms are lending in US dollars on terms equivalent to Bank's ADF terms, the National Government taking the exchange risk, subject to passage of the relevant legislation.

employees of the governments, and progress at the national level on reviewing the overall tax system. In addition, the following specific conditions will also apply for the National and State governments. The National Government and at least two States must meet these for the second tranche to be released :

(i) achievement of the downsizing/ERS targets as set out in the Policy Matrix and consistent with the Development Policy Letter;

(ii) enactment of the new Foreign Investment Act by the National Government and the States; and

(iii) enactment by the National Government of the Customs Law and amendment of the Gross Revenue Tax Law (removing taxation disincentives on exports), both under Title 54 of the Code of FSM.

70. It is proposed that the loan be disbursed to the National Government in two tranches, the first tranche being $10 million and the second $8 million. The Counterpart Funds will be disbursed to each State and the National Government under each tranche as shown in Table 2.

Table 2: Program Loan Tranching and Allocation of Counterpart Funds ($ million)

Government	1st Tranche	2nd Tranche	Total
Chuuk State	3.0	2.3	5.3
Kosrae State	1.0	1.0	2.0
Pohnpei State	2.5	1.7	4.2
Yap State	2.0	1.5	3.5
National	1.5	1.5	3.0
TOTAL	10.0	8.0	18.0

C. Technical Assistance

71. The EMPAT team under TA No. 2294-FSM has been assisting the National and State governments in developing the reform programs and will continue to support them in implementing actions under the programs. At present EMPAT comprises two resident international advisers supported by two relatively inexperienced domestic economists. EMPAT's resources need augmenting by a third adviser to effectively assist all four States and the National Government. In addition an increase in the short-term consulting services component of the TA is needed to help strengthen the capacity of the governments to monitor the social and economic impacts of the policy reforms. This component will directly assist the varied Offices of Planning and Statistics in designing and developing a statistical system that will meet the needs for monitoring social and economic impacts. These services will require an additional $660,000; there is an uncommitted balance of $120,000 in TA No. 2294-FSM. The Bank will thus provide an additional $540,000 on a grant basis. Continuity and consistency of policy advice are essential in such a complex and sensitive reform program, and thus it is planned that the contract of the EMPAT team itself will be extended to provide these services, the selection of additional individual consultants for EMPAT being subject to agreement with the Bank as in the current contract (see Appendix 5 for details).

72. In addition, as foreshadowed in para. 60, TA estimated to cost $380,000 will be provided by the Bank on a grant basis to assist in developing a nationwide investment promotion plan and conducting a review of the financial sector, focusing in particular on lending institutions and their lending instruments and modalities. The objectives of the TA are to (i) improve the private sector investment climate by developing a nationwide coherent investment promotion plan, and (ii) enhance commercial credit availability through reform measures (see Appendix 5).

73. The Bank, under its regular program of assistance to the FSM, is also providing assistance to the three key development sectors of agriculture, fisheries, and tourism, and thus no specific TA for these sectors is included with this program loan. The Bank's 1997 TA program includes a TA to assist development of the tourism sector. The proposal is still being developed but is likely to follow the lines of TA No. 2483-RMI, Tourism Development, in the Republic of the Marshall Islands, which is helping establish a tourism council/organization in the private sector, providing training to staff, and assisting in the development of a tourism growth strategy. In the FSM, embryo tourism offices have been established by the private sector in all States. The TA would help in the establishment of a national tourism council that would involve both government and the private sector, and help train staff in all five offices and in developing strategies for the FSM as a whole, and for the individual States.

74. The Bank's ongoing TA program of assistance to the FSM includes assistance in both agriculture and fisheries. Further assistance is required in both these areas, and is included in the Bank's future program, but details have yet to be finalized. The agriculture TA is still ongoing and has yet to define the scope of further assistance. Findings of the ongoing fisheries TA concluded that important policy and program decisions, based on the output of the TA, had to be made by the Government before the exact scope of further assistance could be defined. A technical summit held in the FSM in December 1996 developed a series of recommendations, based on which a follow on advisory TA is being drafted that will focus on development of a single fisheries management agency, a prerequisite for private sector development. The policy recommendations and draft TA will be discussed by the FSM Congress in May.

VI. PROGRAM JUSTIFICATION, IMPACT, AND RISKS

A. Program Justification

75. The decline by over 20 percent in the Compact's base grant in October 1996, together with the prospect of a more substantial decline — and possibly a termination — in Compact inflows in FY2001, have prompted the Government to introduce a major public sector reform program. While the Compact has served in the past to support domestic incomes and consumption patterns at levels far beyond the capacity of domestic resources to sustain, the Government recognizes that a major adjustment is now required to ease the transition towards instituting greater symmetry between domestic factor productivity and material consumption levels. It recognizes that the country has to become more self-reliant and less dependent on US support and, by initiating adjustment now, it seeks to manage that transition rather than have events eventually force themselves upon it. Adjustment is inevitable and will have to take

76. In general terms, the FSM governments have decided that restructuring requires redefining and reducing the role of government on the one hand, and fostering a burgeoning private sector to become the engine of future economic growth on the other. However, considering that inflows under the Compact and other US programs currently constitute some 56 percent of the country's public revenue, the extent of the economic restructuring required to accommodate a major reduction or termination in an amount so large, is enormous. Moreover, the individual components that comprise the PSRP are themselves complex. As noted earlier, these include relate to reducing the size and salary levels of the civil service; increasing domestic revenue generation through a reform of the tax system, restructuring government operations and enterprises, mitigating the social and economic impact of major fiscal adjustment, and fostering private sector activity. Designing and managing any of these individual components is difficult enough, but designing and managing them simultaneously across five governments as part of an integrated and harmonized adjustment plan is even more so.

77. Unassisted, the governments do not possess adequate financial and technical resources to undertake the extensive reforms required. The critical policy reforms that are to be introduced as the main focus of the PSRP, together with the commitment of the governments to the reform process, the foresight shown in beginning to adjust sooner rather than later, and the anticipated long-term benefits of the PSRP, collectively provide justification for both the PSRP and for the Bank to provide assistance to meet part of its financial costs. TA is being, and will continue to be, provided by the Bank to support policy reforms and PSRP implementation.

78. The aims of the proposed loan, and of the far-reaching reforms on which it is contingent, are to mitigate the initial impact of civil service retrenchment, to underpin government revenue growth and expenditure reduction so as to foster more sustainable fiscal operations, and to eliminate many of the barriers and distortions that currently operate against the interests of private investment and initiative. Only by promoting such reforms can the FSM can ever hope to achieve greater self-reliance, and thus be able to face the realities of the post-Compact world.

B. Program impact

79. The reductions in personnel expenditure for the civil service through downsizing and salary cuts have already begun, and are to be extended over the next two years or so. Their impact will be as severe for the population at large as they will be beneficial for long-term fiscal stabilization. As they occur, they will have an immediate impact — and are already having an impact — both on those individually affected by retrenchment and salary cuts as well as on their extended families. To these effects must be added those potentially deriving from the planned reform of the tax system which, whatever details finally take shape, will inevitably serve to reduce disposable incomes. These two aspects of fiscal adjustment taken together will, via the income/employment multiplier and the typical degree of interdependence within extended families, result in an initial decline in domestic incomes and GDP, a rise in unemployment and underemployment, a reduction in material consumption standards, and a possible cutback in the provision of health and education facilities. Given that the Compact has traditionally served to maintain domestic consumption levels above those sustainable by domestic resources alone, this initial reduction in domestic incomes and consumption is an

inevitable consequence of a decline in Compact inflows, and a crucial part both of the adjustment to that decline and of the reduction in the role of government.

80. However, not introducing the reforms now would merely delay their introduction; it would lead to even greater adverse consequences in the future. Recent fiscal trends are simply unsustainable, particularly after FY2000 for all FSM governments, and for Chuuk, Pohnpei, and Yap even over the near term. Thus, inaction would still result in profound consequences throughout the FSM, be they sooner or later, and would probably force on the five governments the need for even more abrupt salary reductions and lay-offs in the future than are now being contemplated as part of the PSRP. The economic instability from what would inevitably be a deep recession would not only bring in its wake adverse direct effects on incomes and employment, but would also have a major indirect impact on private sector confidence. This in turn would deepen recession and delay any recovery. Moreover, while this would affect both the poor and nonpoor, it would almost certainly affect the poor more seriously.

81. Similarly, trying to implement the PSRP without providing some form of social safety net for those directly affected, and without assistance to promote the private sector, would also have adverse consequences that are potentially worse than those envisaged under the PSRP. Retrenchment without compensation, particularly when added to the tax reform envisaged, would cause immediate hardship for those directly affected as well as lead to the same secondary effects through the income/employment multiplier as those cited above. Thus, a major loss of welfare would be immediately felt by those retrenched and by their extended families if no financial assistance were provided for them, and eventual economic recovery would be delayed if these individuals were also to be denied access to counseling and training to prepare them for possible new employment. It is also worth noting that the governments envisage that many of the retrenched staff are likely to be active persons who volunteer for retirement with clear intentions to develop activities in the private sector; they would in fact put their termination payments to productive use in developing activities in the private sector, such injection into the private sector itself helping to mitigate a possible recession. Furthermore, as demonstrated in Appendix 6 (Poverty Impact Assessment), most households have access to land and home production opportunities that will mitigate the direct impact of retrenchment. Those directly affected by the PSRP are not the poor, those in the public service generally being better off and better educated, with many receiving some other income besides wages. The poor, however, will be affected indirectly by the reforms as incomes decline. Development of the private sector and the return to full employment potentially is the most positive impact on the poor from the PSRP.

82. EMPAT has developed a rudimentary economic model to monitor the affects of the reforms on family incomes. The model makes conservative assumptions about the growth of the private sector following the targeted initiatives of the PSRP. It indicates that there will be a decline in total incomes following the stepdown in Compact funding in October 1996 but that incomes will return to 1996 levels within three years. Incomes might grow somewhat through to 2001 (the possible end of Compact funding), when a significant decline would occur; the severity of this decline is very much dependent on how the productive sectors would have developed over the preceding four-year period. Without the reforms, however, the magnitude of the decline will be severe.

83. Thus, while the fiscal adjustment envisaged will lead to a loss of welfare and to an initial decline in GDP, the PSRP and the program loan proposed to support it seek to mitigate initial hardship by providing temporary compensation payments, to moderate economic recession by helping to underpin effective demand over the medium term, and to assist the private sector so that it will be in a better position to lead the way out of the recession. As such, a profound restructuring of the economy is sought, involving a much reduced role for the governments of FSM and a rejuvenated private sector.

C. Program Risks

84. There are fundamentally three major risks associated with the PSRP: a possible lack of expertise and institutional capacity to effectively implement the reform program, a possible lack of political will to implement the program fully, and the failure of the private sector to respond as visualized.

85. The National and State governments have only recently moved from an emphasis on financial and cash management to a more forward looking economic and policy development role and as yet have limited skills in these areas. The ongoing Bank-financed EMPAT project will be critical in assisting the governments in this regard, and the proposed augmentation of EMPAT resources will enable the team to spend more time with the State governments, which is seen as a major concern. UNDP assistance is also being provided to State planning offices. The FSM is paying more attention to training in economic policy analysis, and the counterpart staff to EMPAT will receive overseas training as part of the augmented TA.

86. Unforeseen developments may cause a weakening of the present strong political commitment to implement the PSRP, or prevent target dates from being met, although there is quite a wide appreciation among political, cultural, and business leaders as well as within society generally that change has to occur. Nevertheless, it must be recognized that the FSM — and particularly its constituent States — is a series of very small societies where implementing policy decisions assumes very much more of a personal dimension than in larger countries. This will be minimized by the introduction of largely voluntary early retirement schemes as an integral part of the PSRP, as well as by following transparent retrenchment procedures should these be needed.

87. Similar risks could arise with respect to introducing the necessary reforms to the tax system or to government-owned entities. Pressures to resist tax increases or managerial changes in state-owned enterprises could arise if the adverse impact of the PSRP turns out to be more severe than envisaged, or if the private sector fails to emerge to take up some of the slack left by government downsizing. In these circumstances, the governments may decide to delay decisions, although this would result in even more abrupt — and possibly more destabilizing — changes having to be subsequently introduced.

88. The third major risk is the possibility that the private sector will be unable to develop fast enough to take up the slack left by the downsized public sector, or to become the engine of national growth over the long term. Over recent decades, the ease of access to Compact funds and to the imports such funds have financed has weakened local initiative as well as encouraged the growth of the public sector. This has driven up public sector

employment and wages; led to secondary increases in trading, house construction, and other noninternationally tradable activities; and crowded out potential producers of tradable goods and services, or rendered their products uncompetitive internationally. With such experience, few natural resources, and only a small domestic market, the governments are concerned that, with the best possible effort, private sector expansion might remain limited.

89. Although small, the FSM has natural resources and some experience in exploiting them, notably in the case of fishing (much of the product of which is exported by air to the Japanese market), and of agriculture (where there is still a tradition of exploiting one's ancestral land, even when working in paid urban employment). Indeed, but for the emergence of quarantine issues in recent years, the exports of several agricultural products, particularly to Guam, would have been significantly larger than they are at present. There is substantial agricultural potential, enormous fishing potential, and not insignificant tourism potential. Local exploitation of these resources would be feasible if the current distortions were removed from the policy environment, training courses were modeled on local rather than on foreign requirements, the Government were to adopt a promotional role rather than maintain an interventionist one, and patience were shown by all concerned. Moreover, as the restrictions on working in the US remain in place and possibly become more severe, there should be added incentive for FSM citizens to look to the domestic economy for advancement rather than to foreign countries.

VII. ASSURANCES

90. The Government has given the assurance that it will continue to implement the PSRP in accordance with the Development Policy Letter and the Policy Matrix (Appendixes 2 and 3). It has also been agreed that the Government and the Bank will continue their policy dialogue on problems encountered during implementation of the PSRP and on desirable changes to overcome or mitigate such problems.

91. The Borrower will ensure that the Counterpart Funds withdrawn from the Special Account to be established for the purpose of the loan will be (i) used in support of the reforms set forth in the Development Policy Letter and Policy Matrix, and (ii) allocated among the Borrower and the States as set out in para. 70. The Borrower will make appropriate arrangements with the States to ensure that the Counterpart Funds allocated to them are disbursed to them upon their compliance with their obligations set forth in the Policy Matrix, including the timely satisfaction of the conditions for release of the second tranche. Such funds will be made available to the States on terms and conditions satisfactory to the Borrower, the Bank, and the States.[1]

92. The Borrower and the States will carry out a review of the following no later than 30 November 1997 or such other date as the Borrower and the Bank may agree upon: (i) the progress of the Borrower and the States in implementing the policy reforms set out in the Development Policy Letter and Policy Matrix, including fulfillment of the conditions for release of the second tranche as set out in para. 69; and (ii) the impact of these and earlier reforms on the public sector. At the end of the Program period, the Borrower and the Bank will jointly

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1 The terms are lending in US dollars on terms equivalent to Bank's ADF terms, the National Government taking the exchange risk, subject to passage of the relevant legislation.

review the implementation of the Program and evaluate its benefits in accordance with a schedule and terms of reference mutually agreed upon.

VIII. RECOMMENDATION

93. I am satisfied that the proposed loan and technical assistance would comply with the Articles of Agreement of the Bank and recommend that the Board approve:

(i) the loan in various currencies equivalent to Special Drawing Rights 12,979,000 to the Federated States of Micronesia for the Public Sector Reform Program, with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board; and

(ii) the provision of supplementary technical assistance for TA No. 2294-FSM, Policy Advisory Team for Economic Management, on a grant basis, in an amount not exceeding the equivalent of $540,000 to the Government of the Federated States of Micronesia.

MITSUO SATO
President

3 April 1997

APPENDIXES

Number	Title	Cited On (page, para.)
1	Profiles of the Four States of the Federated States of Micronesia	1,4
2	Development Policy Letter	12,48
3	Consolidated PSRP Policy Matrix	12,52
4	Program Framework	13,52
5	Technical Assistance Accompanying the Loan	20,71
	(i) Expansion of Policy Team for Economic Management (ii) Investment Promotion and Financial Sector Review	
6	Poverty Impact Assessment	23,81

SUPPLEMENTARY APPENDIXES
(Available on Request)

A	Summary of Compact Agreement
B	Government Finances
C	Taxation Issues
D	Socioeconomic Conditions in the FSM
E	Policy Matrices (for individual governments)

PROFILES OF THE FOUR STATES OF THE FSM

A. General

1. The Federated States of Micronesia (FSM) consists of the four States of Chuuk (formerly Truuk), Kosrae, Pohnpei, and Yap and covers over 600 islands spread across more than three million square kilometers of ocean, stretching 2,900 kilometers from east to west. The FSM's exclusive economic zone covers 3.1 million square kilometers. The total land area is about 700 square kilometers, with Pohnpei comprising almost half, and the rest equally divided among the other three States. Most of the islands are high and of volcanic origin, with good soils, abundant water, and lush vegetation, although Yap and Chuuk also include low coral islands.

2. The population of 105,500 has eight major indigenous languages, and no two States have the same native tongue, English being used as the common language. Each State has its own culture and character. Pohnpei State, which is also the seat of the National Government, has a population of 33,700; Chuuk, 53,300; Yap, 11,200; and Kosrae, 7,300. Prior to the American administration the islands of the FSM had traded with and been colonized first by Spain, then Germany, and finally Japan up to the Second World War.

3. The FSM is a new and relatively loose confederation of States, with the States strongly maintaining their individual identities and having significant autonomy over much of their affairs including a high degree of fiscal autonomy. The FSM government system is based on the US structure. Each State has its own constitution, which determines the balance of power among the three branches of government (executive, legislative, and judicial) and the levels of government (National, State, and municipal). The FSM National Congress is unicameral, with 14 senators; each State elects one senator at large (from whom Congress elects the president and vice president), and ten are elected based on population (five from Chuuk, three from Pohnpei, and one each from Kosrae and Yap). Each State has a governor elected by popular vote, an elected legislature, and a State court. At the municipal level, the traditional leaders play an active role in government.

B. Pohnpei State

4. Pohnpei, the seat of the National Government, is the largest State by land area. It is composed of a main island (98 percent of its total land area), five inhabited outer islands, and three small atolls seasonally inhabited by small families. The atolls are 225 kilometers to the southeast, 716 kilometers to the southwest, and 290 kilometers to the northwest of Pohnpei Island. Pohnpei Island is high, volcanic, and roughly circular, with an average 21 kilometer diameter, edged with coves and jutting peninsulas. It has a land area of 334 square kilometers. The interior has rugged mountain ridges and deep valleys. The coastline is mainly tidal flats and mangrove swamps, without sandy beaches. It has the wettest climate, with the town of Kolonia having an average of nearly 500 centimeters of rain a year, and the interior over 1,000 centimeters. The rains support a number of large river systems capable of running hydropower generators, large forests, and a watershed reserve. Temperatures average 27 degrees centigrade.

5. The population is 33,700, with about 90 percent living on Pohnpei, of whom 80 percent are Pohnpeians, the rest being a mixture of other Micronesian races but including some Polynesians. Pohnpeian is the main indigenous language, but English is widely spoken. Kolonia has a population of about 6,500. Palikir, five miles from Kolonia, is the FSM's new capital. The majority of workers in the monetized economy work for the Government. Pohnpei is also the site of the Pohnpei Agricultural and Trade School (PATS) and the newly established College of Micronesia. Not far from PATS is Nan Madol, an important political, social, and religious center built in 1100 - 1200 AD on artificial islets, which could be a significant tourist attraction if facilities and access are improved. Aside from exports of fish and fish products, small commercial agriculture, and subsistence activities, some local industries thrive such as pepper processing and packaging, and a trochus shell button factory.

C. Kosrae State

6. Kosrae is one of the least spoiled and least developed areas in Micronesia. It is the smallest state in both land area and population. It is the most eastern island in the FSM and consists of only one island formation of 108 square kilometers, one third the size of Pohnpei, with no outer islands. The interior is rugged, rising to over 600 meters. Rainfall averages 470 to 500 centimeters a year, with average temperatures of 27 degrees centigrade.

7. The population of about 7,300 live in villages around the coast. Kosrae once had the most stratified society in Micronesia when ruled by paramount chiefs. Religion is an essential part of Kosraen culture, 90 percent of the population being Congregationalists and the church having a strong influence on most aspects of life. Arable land is cultivated mostly for subsistence farming and small-scale citrus production. Even with excellent small harbors and rich marine life, fishing has remained a subsistence activity. Kosrae has unspoiled coral reefs, which together with its natural beauty and unspoiled life style offer opportunities for tourism. Like all the States, Kosrae has its own airstrip.

D. Chuuk State

8. Chuuk, where practically half of the population lives, has no one large island. Instead Chuuk includes 15 high islands and over 70 small flat coral islets in a very large lagoon of 2,130 square kilometers that is 64 kilometers at its widest, enclosed by 225 kilometers of barrier reef. During the Second World War the lagoon became the Japanese Imperial Fleet's most important Central Pacific base, and today the 60 sunken ships lying in the shallow lagoon waters are a major diving attraction. The whole lagoon was once one large volcanic island, most of which has sunk; the 15 high islands in the lagoon are the tallest peaks of the original island. The outer islands, about 22 percent of the land mass, are composed of coral and are mostly atolls. Annual rainfall averages 360 centimeters in the lagoon, and temperatures average around 28 degrees centigrade.

9. One third of the population of 53,300 live on the island of Moen. In Chuuk, each island has a predominant clan, and the traditional system still influences economic life and decision making. Chuuk is perhaps the poorest of the States, the steep slopes making cultivation difficult and less reliable for subsistence production than in the other States. Chuuk has poor mangrove fringes. The outer islands of sandy soil grow coconut palm and some taro

patches. However, the lagoons, reefs, submerged reefs, and banks have rich stocks of marine life, making fishing its prime industry, while the lagoon supports a thriving tourist diving industry. Chuuk has the only large hotel in the FSM.

E. Yap State

10. Yap, the westernmost state and a stronghold of Micronesian tradition, consists of 4 large adjoining high islands (referred to as Yap proper); 4 low-lying coral outer islands; and 11 atolls (except Fais, a raised limestone island). Yap proper is 830 kilometers southwest of Guam and can be reached by air from the rest of the FSM only by travelling through Guam. Yap proper accounts for 80 percent of Yap States total land area; is the least wet, suffering from occasional dry seasons; and is less forested than the other high islands in the FSM. Unlike the other high islands in Micronesia, which are volcanic in origin, Yap proper was formed by land upheavals of the continental shelf. Consequently, the interior comprises gentle rolling hills rather than being mountainous, and only 12 percent is suitable for agricultural development, although this has not been fully utilized. The outer islands are smaller and more dispersed than in the other States, spreading 960 kilometers to the east towards Chuuk and occupying over 40 percent of the FSM's sea area. They have poor, sandy soils, limiting agriculture to coconut palm forests and intensive subsistence gardening. Offshore fishing has significant potential, and transhipments through Yap are already significant.

11. The population is presently 11,200, with 65 percent living on Yap proper. The Yapese have been reluctant to adopt western ways, and their culture remains largely undiluted by outside influences despite four colonial administrations. They still maintain their own customs and traditions, and many wear the traditional loincloth. In addition to an elected legislature, Yap's constitution established two councils of traditional leaders (for chiefs from Yap proper, and from the outer islands). The traditional chiefs still exercise strong influence on government, determining who runs for office, and the councils have the right to veto legislation that affects traditional customs.

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Secretary of Finance
(Minister of Finance)

March 17, 1997

President Mitsuo Sato
Asian Development Bank
0980 Manila, Philippines

Dear Mr. Sato:

Re: FSM Public Sector Reform Program
Development Policy Letter

The Government of the Federated States of Micronesia (FSM) is committed to implementing a soundly based economic Policy Reform Program (PRP). The goal of the program is to strengthen the FSM economy and make it more resilient to changes in the world economy. On December 6, 1995, the FSM Government presented its PRP to the Consultative Group (CG) meeting in Manila. The PRP encompasses a comprehensive economic reform program with four objectives: (i) reducing reliance on external assistance, (ii) increasing the output and competitiveness of the productive sectors, (iii) diversifying the sources of external finance, and (iv) ensuring growth leads to more sustainable development.

Since initiating the reform program the Government has made significant accomplishments on specific objectives and some progress toward achieving the Nation's goal. On October 28, 1996, the FSM Government reported on progress made so far in implementing specific elements of the PRP and also presented a clear timetable for reforms underway. At that time the Government presented its Public Sector Investment Program which has as a key feature in all five Governments the Public Sector Reform Program. This program began in fiscal year 1996 and will run through fiscal year 1998. To assist in this process the Government will request a loan of $18 million from the Bank

OBJECTIVES OF THE PUBLIC SECTOR REFORM PROGRAM

The Government, with advice from the Bank-supported Economic Management Policy Advisory Team (EMPAT), has identified the major steps needed to reduce the dominance of the Public Sector in the FSM economy. The PSRP has been endorsed by the CG and the participants in the National and State Economic Summits.

The overall goal of the PSRP is: *To shift the balance of economic activity away from the public sector to the private sector.*

The PSRP will achieve this goal through the following five objectives:

1) Reduce the Size and Operating Cost of Government

The five Governments of the FSM are committed to adjusting their expenditures to sustainable levels. The Governments have demonstrated this commitment over the past five years, during which time they have succeeded in reducing expenditure by five percent in nominal terms. However, the 1997 stepdown in Compact funding will reduce State Government revenues by over ten percent. Adjusting to this reduction and preparing for the uncertainties beyond the year 2001 requires substantial cuts in Government expenditures. This will be achieved through a combination of measures which are clearly outlined in the policy matrices

Reform actions are already well underway, most notable are the rigorous reforms implemented by our largest State–Chuuk–which has effectively implemented the initial package of promised measures to deal with its own fiscal crisis, including:

- a 20 percent reduction in nominal pay for all employees and elected officials as a result of a reduction in the work week from five days to four days;
- an increase in sales tax rates and a broadening of its base;
- a freeze in hiring and salary increases for the public sector;
- a reduction in the subsidy for the Utility Corporation and an increase in the autonomy given the new management over pricing and operations which has resulted in significantly improved collection and service performance;
- a reduction in other government expenditures, including a 50 percent cut in travel costs and a substantial reduction in medical referrals abroad.

Over and above the initial package of reform measures, the Chuuk State Government has also enacted laws and implemented Executive orders which will reduce the size of the public service workforce by over 20 percent in the coming months.

While the other States and the National Government did not face the same sort of fiscal crisis, they have implemented hiring freezes, ended seniority and cost of living increases, and frozen promotions. Combined with the Chuuk cut in pay, total spending on all FSM government employees is down nearly 20 percent in nominal terms between fiscal year 1995 and the budgets currently in effect for fiscal year 1997.

2) Increase Domestic Revenue Generation

The National Government will take the lead in reforming the national tax regime to increase revenues generated from domestic economic activity. Due to the revenue-sharing arrangements with national tax collections, this will contribute significantly to revenue raising efforts of the States. The State Governments will reform state tax regimes as well as introducing cost-recovery policies to increase revenues from user fees and other charges. The implementation of the PSRP will address the need

to increase revenues through rate and structural reforms and, perhaps more importantly, through improved collection efficiency and effectiveness.

3) Restructure Government Operations and Public Enterprises

The five Governments will individually review and then reform existing government structures with the intention of improving efficiency and cost-effectiveness of priority service provision, while identifying existing functions which should be reduced, eliminated or shifted to the private sector. A major component of this review and reform will focus on public enterprises to reduce public subsidies, lower costs and improve the quality of services delivered to the public.

Considerable progress has already been made in this area, especially in the public utilities sector. All four States have commercialized their utilities by setting up commercially based Utility Authorities, specifically:

- The Pohnpei Utility, in the second largest State, has advanced the furthest, increasing income by about 40 percent from electricity charges, rationalizing the rate structure, and essentially covering both its current and investment costs. This has been implemented despite strong protests from consumers, some of whom must now pay double or even triple their previous charge for electricity. The FSM government views the Pohnpei utility reforms as being the result of extremely effective donor support—policy conditions were clearly spelled out by the US Department of Interior's Operations and Maintenance Improvement Program, technical and financial assistance was received through the same program, and a major physical investment was supported by the Government of Japan. This has been a success story which we plan to repeat in other States and we anticipate that such successes can be built upon in other sectors through collaborative implementation of our Public Sector Investment Program.

The other States have also carried out reforms:

- The Yap utility is meeting all operating costs after recent rate increases;
- The Kosrae utility has reached 70 percent of current cost recovery and has set a clear schedule to reach full operating cost recovery in the next two years;
- Chuuk State, recovering from near total failure of its power system, has fully committed to commercialization. While cost-recovery is still less than 50 percent of operating costs, there has been a concerted effort to improve this as evidenced by a strict requirement for household and business customers to pay utility arrears before being reconnected to the now fully functioning power supply.

4) Mitigate the Negative Social And Economic Impacts of Public Expenditure Reductions

The five Governments will separately establish early retirement schemes to offer incentive packages to government employees who either volunteer to leave public service or who lose their jobs as a result of government restructuring. The financing required for this component of the PSRP is a significant share of the assistance requested from the Bank. The funds disbursed to departing employees are intended to cushion the impact of income reductions as well as, in many cases, to assist the transition to productive employment in the private sector. Each government will also

implement outplacement counseling services and training programs to address redeployment within government and transition to private employment. The UNDP is extending valuable support to assist in training through its Entrepreneurial Development Centers in all four States.

5) Support Development Of The Private Sector

The five governments will implement the recommendations of the National and State Economic Summits which clearly supported a revised role for Government in support of private sector growth. The key elements will be improvements of the enabling environment for private sector investment: expansion and improvement of infrastructure, reform of land tenure arrangements, reforms to State and National foreign investment laws, and increased access to credit by small entrepreneurs through the commercial banking system.

CONCLUSION

Financial and technical support from the Bank in conjunction with determined efforts and sustained commitment on the part of the five Governments in the FSM will ensure progress toward our stated goal. The National Government is committed to fully implement the comprehensive policy actions as delineated in the attached Policy matrices. 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 supported by EMPAT; however, the implementing agency will be the National Department of Finance. 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 the Bank to delay the release of finances to those Governments which have fully met the conditions to which they committed. The FSM Government views the PSRP as a pioneering effort in conditioned collaboration with the Bank and other donors who may be contributors of financial and/or technical support.

Yours sincerely,

John Ehsa

John Ehsa
Secretary of Finance

Attachment: Five (5) Policy Matrices 1/

1/ Consolidated by the Bank into one policy matrix. The five policy matrices are at Supplementary Appendix E.

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period (March 1999)	Implementation Method
Section 1: Reduce Size and Operating Costs of Civil Service *Public Service Downsizing*				
All	1. Establish task forces on Government Restructuring to determine realistic and sustainable staffing needs.	1. Complete report of the task force on government restructuring with fixed targets for realistic and sustainable staffing needs.		Executive action
N	2a As part of FY97 budget process, set operating expenditure reduction targets of 10% annually and personnel reduction targets of 5% in FY97 and 20% in FY98	2a Reduce operating expenditures by 10% from FY97 level and reduce personnel by 5% from FY96 level	2a FY99 operating expenditures reduced by 10% from FY98 and personnel by 20% from FY96 level	Executive Action Legislation
C	2b Set personnel reduction target as part of FY97 budget process: a) 11% reduction by 31 Dec 96 b) 21% reduction by 31 May 97 c) 29% reduction by 31 May 98	2b Reduce personnel in Public Service by 21% from FY96 level.	2b Reduce personnel in Public Service by 29% from FY96 level.	Executive Action
K	2c Set personnel reduction target as part of FY97 budget process: 13% reduction by mid-97	2c Reduce personnel in Public Service by 13% from FY96 level.		Executive Action Legislation
P	2d Set personnel reduction target as part of FY97 budget process: a) 10% reduction by mid-97 b) 20% reduction by mid-98 c) 25% reduction by mid-99	2d Reduce personnel in Public Service by 10% from FY96 level	2d Reduce personnel in Public Service by 25% from FY96 level.	Executive Action
Y	2e Set personnel reduction target as part of FY97 budget process: a) 17% reduction by mid-97 b) 25% reduction by mid-98 c) 28% reduction by mid-99	2e Reduce personnel in Public Service by 17% from FY95 level. Review adequacy of 28% force reduction	2e Reduce personnel in Public Service by 25% from FY95 level. Review adequacy of 28% force reduction	Executive Action
N	3a Hiring freeze for Public Service positions is implemented and reflected in the FY97 approved budget	3a Hiring freeze for Public Service is maintained	3a Hiring freeze for Public Service is maintained	Executive Action

KEY: N = National Government, C = Chuuk State, K = Kosrae State, P = Pohnpei State, Y = Yap State.

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period March 1999	Implementation Method
Section 1: Reduce Size and Operating Costs of Civil Service (Continued)				
Public Service Downsizing (Continued)				
C	3b Hiring freeze for Public Service positions is implemented and reflected in FY97 approved budget	Hiring freeze is maintained	Hiring freeze is maintained, but with review by task force	Executive Action
K	3c Institute a rigorous assessment process for hiring, promotions, and reclassifications	3c Maintain a rigorous assessment process for hiring, promotions, and reclassifications	3c Maintain a rigorous assessment process for hiring, promotions, and reclassifications	Executive Action
P	3d Hiring freeze for Public Service positions is implemented and reflected in the FY97 approved budget	3d Hiring freeze for Public Service is maintained with review by sub-committee of Economic Planning Commission for any essential/emergency hiring.	3d Hiring freeze for Public Service is maintained with review by sub-committee of Economic Planning Commission for any essential/emergency hiring	Executive Action
Y	3e Freeze promotions, reclassifications, and merit allocations	3e Approved budget reflects freeze on promotions, reclassifications, and merits	3e Approved budget reflects freeze on promotions, reclassifications, and merits	Executive Action
Wage/Salary Reduction				
N, C, P, Y	1a Freeze automatic step increases	1a Maintain freeze on automatic step increases	1a Maintain freeze on automatic step increases	Executive Action
K	1b Revise step increase from annual to biennial	1b Approved budget reflects delay in step increases, reflected in the FY98 budget	1b Approved budget reflects delay in step increases, reflected in the FY99 budget	Executive Action
K	2 Across the board wage cut of 12.5% for all Government employees	2 Approved budget reflects wages cut	2 Approved budget reflects wages cut	Executive Action Legislation
N	3a Restrict leave accrual	3a Approved budget reflects reduced leave accrual	3a Approved budget reflects reduced leave accrual	Executive Action
C, K, P, Y	3b Replace overtime payments with compensatory time in lieu of cash	3b Maintain compensatory time in lieu of cash policy	3b Maintain compensatory time in lieu of cash policy	Executive Action Legislation
K	3d Replace merit wage increase with merit award	3d Approved budget reflects merit award	3d Approved budget reflects merit award	Executive Action
P	3e Reduce regular and contract service salaries by 12.5%	3e Approved budget reflects personnel expenditure reduced by 12.5 %	3e Approved budget reflects personnel expenditure reduced by 12.5 %	Executive Action Legislation

KEY: N = National Government, C = Chuuk State, K = Kosrae State, P = Pohnpei State, Y = Yap State

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period March 1999	Implementation Method
Section 1: Reduce Size and Operating Costs of Civil Service (Continued)				
Wage/Salary Reduction (Continued)				
C	4 Reduce wage bill by 20% from FY95: a) reduce work days from 5 to 4 per week for Public Service, by mid-96 b) reduce exempt employees' wages by 20%, by mid-96	4a Approved budget reflects reduction in wages bill	4a Approved budget reflects reduction in wages bill	Legislation
Other Cost Reduction				
C, K, P	1 Complete report analyzing all operating subsidies/transfers from the Government	1 Eliminate all operating subsidies and transfers	Maintain elimination of operating subsidies and transfers	Executive Action Legislation
K	2 Review leave accrual provisions of Executive Service Regulations	2 Revise leave accrual provisions		Executive Action Legislation
P	3 Restrict leave accrual to a maximum of 80 hours	3 Approved budget reflects reduced leave accrual	3 Approved budget reflects reduced leave accrual	Executive Action
Section 2: Increase Domestic Revenue Generation				
National Taxes				
N	1a Review current taxation legislation and draft reforms to import and sales tax	1a Pass legislation to introduce reforms		Executive Action Legislation
C, K, P, Y	1b Support amendments to national tax legislation	1b Support amendments to national tax legislation		Executive Action Legislation
State Taxes				
C, Y	1a Complete report analyzing all State taxes and recommending revisions or additions to increase revenue	1a Increase State revenues	1a Increase State revenues	Executive Action Legislation
K	1b Review State tax system to improve efficiency and effectiveness	1b Increase State revenues by 5% above FY95 levels	1b Maintain State tax revenues at or above FY97 levels	Executive Action
P	1c Complete report analyzing all State taxes and recommending revisions or additions to increase revenue	1c Increase State revenues by 10% above FY95 levels	1c Increase State revenues by 20% above FY95 levels	Executive Action Legislation

KEY: N = National Government, C = Chuuk State, K = Kosrae State, P = Pohnpei State, Y = Yap State.

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period March 1999	Implementation Method
Section 2: Increase Domestic Revenue Generation (Continued)				
State Taxes (Continued)				
Y	1d Improve collection rate for existing taxes	1d Collection rate at least 80% of levied taxes	1d Collection rate at least 80% of levied taxes	Executive Action
User Fees				
C	1a Complete report analyzing all user fees and recommending revisions or additions to increase revenue	1a Increase state public service user fees	1a Increase state public service user fees	Executive Action Legislation
K	1b Review public service user fees to identify appropriate pricing structure	1b Increase user fee revenues to 60% of service cost		Executive Action
P	1c Complete report analyzing all user fees and recommending revisions or additions to increase revenue	1c Increase user fee revenues by 10% from FY95 levels	1c Increase user fee revenues by 20% from FY95 levels	Executive Action Legislation
Y	1d Analyze all public service user fees and consider revisions or additions to increase revenue	1d Collection rate at least 80% of levied fees	1d Collection rate at least 80% of levied fees	Executive Action
Other Charges				
C, P	1a Complete report analyzing all other charges and recommending revisions or additions to increase revenues	1a Increase other revenues	1a Increase other revenues	Executive Action
Section 3a: Restructure Government Operations				
Functional and Financial Review of Government Departments				
All	1 Complete report analyzing existing Public Service staffing patterns and functions; set FY97-FY99 milestones and targets	1 Legislation passed approving Government restructuring	1 Government restructuring completed	Executive Action Legislation
C, P, K, Y	2 Identify Government activities to be eliminated, privatized, or transferred to other service providers	2 Divest noncore Government activities	2 Divest noncore Government activities	Executive Action Legislation

KEY: N = National Government, C = Chuuk State, K = Kosrae State, P = Pohnpei State, Y = Yap State

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period March 1999	Implementation Method
Section 3b: Restructure Public Enterprises				
Functional and Financial Review of Public Enterprises				
N, C, P, Y	1 Initiate review of public enterprise staffing patterns, operating costs, service provision, subsidy receipts, and other revenues	1 Complete report and make recommendations to improve their economic and financial efficiency	1 Implement recommendations	Executive Action
Reform of Public Utilities				
C	1a Complete Corporate Plan for Chuuk Utilities Corporation (CUC)	1a Complete annual revision of Corporate Plan	1a Complete annual revision of Corporate Plan	CUC Board
K	1b Kosrae Utility Authority (KUA) to prepare annual operations report	1b Complete annual operations report as part of KUA budget process	1b Complete annual operations report as part of KUA budget process	KUA Board
P	1c Complete Corporate Plan for Pohnpei Utilities Corporation (PUC)	1c Complete annual revision of Corporate Plan	1c Complete annual revision of Corporate Plan	PUC Board
Y	1d Complete Corporate Plan for Yap State Public Sector Commission (YSPSC)	1d Complete annual revision of Corporate Plan	1d Complete annual revision of Corporate Plan	YSPSC Board
C, K, P, Y	2 Delegate authority of tariff setting to utility and introduce user-pay policy	2 Utility retains pricing autonomy and utility charges cover operating costs for providing services	2 Utility retains pricing autonomy and utility charges cover operating costs for providing services	Executive Action Legislation
Section 4: Mitigate Social and Economic Impact				
Early Retirement Program				
All	1 Establish early retirement scheme, including financing requirements and identification of eligible staff	1 Offer early retirement to public sector staff and complete report on progress	1 Complete report on progress	Executive Action Legislation
K	2a Offer staff over 55 years of age an annuity equivalent to FSM Social Security pension, payable until recipients become eligible for Social Security	2a Continue annuity program for 55+ years	2a Continue annuity program for 55+ years	Legislation
P	2b Make adequate budget provision for local contribution to ERS	2b 40% of ERS offerees left Government service	2b 100% of ERS offerees left Government service	Executive Action

KEY: N = National Government, C = Chuuk State, K = Kosrae State, P = Pohnpei State, Y = Yap State

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period March 1999	Implementation Method
Section 4: Mitigate Social and Economic Impact (Continued)				
Outplacement and Counselling Services				
All	1 Design staff retraining, skill upgrading, and associated training program	1 Implement training programs	1 Implement training programs	Executive Action
All	2 Establish employee outplacement service	2 Provide information on outplacement and counselling services	2 Provide information on outplacement and counselling services	Executive Action
Section 5: Foster Development of Private Sector				
Investment Climate				
All	1 Review and revise foreign investment procedures	1 Reform current foreign investment guidelines		Executive Action Legislation
P	2a Draft land leasehold system legislation to provide for 50 year leases and improved transferability	2a Pass revised legislation		Executive Action Legislation
Y	2b Introduce Eminent Domain Act	2b Pass Eminent Domain Act		Executive Action Legislation
Financing				
All	1 Review loan guarantee and other financing schemes for small entrepreneurs	1 Complete review and implement a commercial loan guarantee scheme or similar for small entrepreneurs		Executive Action Legislation
C, K, P, Y	2 Review constraints on using land as collateral by banks and commercial lending organizations	2 Pass revised legislation to enable land to be used as collateral by banks and commercial lending organizations		Executive Action Legislation
Infrastructure				
All	1 Develop a Public Sector Investment Program (PSIP)	1 Implement PSIP in approved development budget	1 Implement PSIP in approved development budget	Executive Action Legislation

KEY: N = National Government, C = Chuuk State, K = Kosrae State, P = Pohnpei State, Y = Yap State

Consolidated PSRP Policy Matrix

	Actions Before Board Consideration (April 1997)	Targets for Second Tranche (March 1998)	Targets for End of Program Period March 1999	Implementation Method
Section 5: Foster Development of Private Sector (Continued) *Human Resource Development*				
All	1 Revise school curricula to increase emphasis given to vocational and technical education	1 Increased support for vocational and technical education in approved budget	1 Increased support for vocational and technical education in approved budget	Executive Action
All	2 Initiate adult education and training programs in vocational and technical areas	2 Increased support for adult education and training in approved budget	2 Increased support for adult education and training in approved budget	Executive Action
N, K, Y	3 Ensure postsecondary scholarship programs support training in relevant vocational and trade skills	3 Increased number of scholarships offered to students wishing to study in the key economic development areas	3 Increased number of scholarships offered to students wishing to study in the key economic development areas	Executive Action Overseas Funding Agencies

Key.
N National Government
C Chuuk State
K Kosrae State
P Pohnpei State
Y Yap State

PROGRAM FRAMEWORK

Design Summary	Project Targets	Monitoring Indicators	Assumptions and Risks
1. Goal			
Transformation and development of a more efficient FSM economy as end of Compact funding approaches	Growth in GDP, and particularly in productive sectors of aquaculture, fisheries, and tourism; growth in exports; reduction in food imports	GDP and trade data; foreign exchange earnings	National Congress and State Legislatures implement and support macroeconomic policies to facilitate growth and transformation of the economy.
2. Purpose			
2.1. Reform and reduce the size of the public sector to adjust to declining external resource transfers.	Smaller and more efficient public sector that can be financed by domestic revenue generation	Reduction in numbers employed in the public sector, shown in annual budgets of National and 4 State Governments; legislation on early retirement	National Congress and State Legislatures implement reform programs, reduce budget expenditures, and raise revenue.
2.2. Shift balance of economic activity away from the public sector to the private sector.	Private sector leads growth in agriculture, fisheries, and tourism, and operates former public services/enterprises.	Increased proportion of GDP generated by private sector; increased investment and employment in the private sector	Private sector responds to growth opportunities and new macroeconomic policies. Failure of the private sector to grow as envisaged may lead to weakening of political will to implement whole reform program.
3. Outputs			
3.1. Reduce size and operating costs of the civil service.	Public sector downsizing, wage and salary reduction, other cost reduction (details in policy matrices)	Budgets of 5 governments will indicate personnel numbers, reduced expenditure, etc.	National and State Legislatures approve reform measures and reduced budgets.
3.2. Increase domestic revenue generation	Improved administration, new revenue measures	Revenue collection data; new legislation on taxes	Tax legislation passed; administrative capabilities improved
3.3. Restructure Government operations and public enterprises, divesting some	Functional and financial review of enterprises; reform and privatization	Review reports; divestment privatization of activities	National and State Legislature approve restructuring, divestment, and privatization.
3.4. Mitigate negative social and economic impact of adjustment in public expenditure	Early retirement schemes, training, and outplacement counselling	Number of voluntary retirees; attendance at training courses	Some public servants seek early retirement; others retire to take up opportunities private sector has to offer.
3.5. Foster development of the private sector.	Better investment climate; improved economic infrastructure and better trained manpower resources	New investment legislation; improved financial and economic infrastructure; vocational and school curricula made more appropriate, with increased enrolment	Opportunities exist for private sector growth, particularly in agriculture, fisheries, and tourism.

Design Summary	Inputs/Resources	Monitoring Indicators	Assumptions and Risks
4. Activities Specific activities are detailed in the policy matrices for each of the 5 governments under the 5 components listed above (see Appendix 3), and summarized in Table 1 of the RRP.	National Economic Council and State Budget/Planning Offices, assisted by Bank-financed Economic Management and Policy Advisory Team (EMPAT) Advisory TA in investment promotion and review of financial sector institutions Ongoing advisory TA in fisheries and agriculture and proposed TA in tourism Counterpart funds generated from $18 million program loan Infrastructure investment from Compact and other donor funds Training assistance from ILO and UNDP, US programs, AusAID scholarships	Continued consultants' advice and report, Bank supervision missions Funds provided by governments for early retirement schemes and training programs	Consultants continue to produce quality advice, acceptable to the Governments. Proceeds from Program Loan are released by National Government to State Governments as agreed upon in Loan Documents

TECHNICAL ASSISTANCE ACCOMPANYING THE LOAN

I. Expansion of the Economic Management Policy Advisory Team

A. Background

1. The Economic Management Policy Advisory Team (EMPAT), financed under technical assistance (TA) No. 2294-FSM,[1] has been active in the Federated States of Micronesia (FSM) since May 1995. The two resident advisers have played leading roles in advising the Government of the FSM on a far reaching economic reform program that was endorsed by the Consultative Group of Donors in meetings at the Bank in Manila in November 1995 and October 1996.

2. EMPAT has supported the National Government and all four States in organizing and successfully completing Economic Summits to achieve broadened support for the need to reform economic policies and restructure government in response to declining external support through the Compact of Free Association with the US Government and to cope with the uncertainty about funding levels beyond 2001, when the current economic assistance provisions of the Compact are scheduled to terminate.

3. A core focus of EMPAT has been supporting the five governments in their detailed plans for public sector reform. During the initial phase of the project the two resident advisers focused their efforts on policy formulation and integration into the policy and decision-making mechanisms of the five governments. Increasingly the team is now required to assist in the time-consuming tasks of reform implementation. It has proven impossible to service the needs of all of the governments—opportunities have been missed to advise and inform decision-makers in advance of critical policy choices. The nascent frustration, especially at the State level, will likely grow and is likely to compromise the effectiveness of the reform effort if the team cannot provide more intensive and timely support. An additional resident adviser is needed.

4. The proposed expansion of EMPAT also anticipates a major effort to improve the capacity of the governments in the FSM to monitor the social and economic impacts of the overall economic reforms. This is to be conducted through EMPAT utilizing additional short-term consulting resources, and as a follow-up to initial work by EMPAT in the area of statistical systems. In addition, more resources will be needed for domestic travel.

B. Objectives and Scope

5. A third resident adviser will join the team, which now also includes two local economists, through to the end of the contract in May 1998. The objectives of the TA remain largely unchanged:

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[1] TA No. 2294-FSM: *Policy Advisory Team for Economic Management*, for $2,500,000, approved on 31 January 1995.

(i) to assist the governments of the FSM in formulating economic strategies and policies that will lead to more rapid and self-sustaining growth, and particularly address the major structural problems faced by the nation;

(ii) to assist in reform implementation and in monitoring the effectiveness and impacts of structural reforms; and

(iii) to provide on-the-job training to counterpart staff and to support the development of improved policy analysis and formulation skills at all levels of government.

6. As a member of the EMPAT, the third adviser will help in preparing and implementing an integrated and coordinated set of economic policies that taken together across the five governments, form a coherent economic development strategy. On many tasks the adviser will do much of the analytical work in conjunction with EMPAT's local staff economists. On other tasks, the adviser will assist the Government in accessing and managing the resources available to it through external sources. In addition, the adviser will identify specific tasks requiring highly specialized expertise and will arrange for targeted short-term consultancies funded directly through the EMPAT project.

C. Terms of Reference: Third Adviser

7. The main assignments of the EMPAT are to assist the five governments in the FSM in the activities as outlined in Appendix A of the Consultant Service Contract for TA No. 2294-FSM; summarized, these include:

(i) Assist the governments in formulating, implementing, and monitoring their structural adjustment policies. The resident advisers and short-term consultants will be available to all line departments and the Congress as well as to all the States.

(ii) Draft progress reports with the approval of the Project Director.

(iii) Provide formal and on-the-job training and seminars to government officials.

(iv) Draft the terms of reference for short-term consultants.

(v) Cooperate closely with consultants to the governments under other TAs, and provide comments and suggestions on their activities.

(vi) Select candidates for the project scholarship program for the Bank's approval.

8. The third resident adviser will share functions and responsibilities within the team. As part of the implementation and monitoring of the Public Sector Reform Program (PSRP) loan, the adviser will likely have specific responsibilities covering at least two of the four States of the FSM.

9. The budget implications of this expansion are set out in Table 1 below. in addition to salary, there is provision for international and domestic travel for the third adviser, as well as some increased travel of the other resident advisers to assure effective implementation and monitoring of the PSRP. There is provision for equipment for the third adviser and for one of the two local staff economists (the other being supported through local contribution). Finally, there is provision for increased short-term consulting services, primarily for strengthening the capacity of the governments to monitor the social and economic impacts of the policy reforms — as outlined in paras. 10-13.

D. Short-term Consultant: Increasing the Capacity to Monitor the Social and Economic Impacts of Policy Reform

10. In May and June of 1996, EMPAT implemented a two-month consultancy to review the statistical systems in the FSM. This review recommended implementation of a streamlined social and economic statistical system. A comprehensive reorganization of the activities and efforts of existing staff is necessary. It further identified a program of TA required to effectively institutionalize this within the National and State statistical offices. To effectively monitor the impacts of policy reforms, the National and State governments require sustained TA to redirect their efforts and to train their existing staff in revised tasks.

11. The short-term consultant's activities will include:

(i) confirming that the recommended statistical system adequately addresses the needs for monitoring the social and economic impacts of policy reforms at the National and State levels;

(ii) identifying the sources and methods of collection for all existing social and economic indicators; and

(iii) advising statistical offices on the best methods for collecting, aggregating, and reporting these statistics.

12. To create the most significant new element of the statistical system, namely production accounts, the consultant will work with State officials to build benchmark accounts for 1995 or 1996, and to set up programs for annual and quarterly surveys. This effort will also result in collection of employment data and other relevant indicators. In particular, the activities will include:

(i) obtaining directories of establishments;

(ii) interviewing establishments in various sectors on a pilot basis and modifying proposed questionnaires accordingly;

(iii) enumerating all remaining establishments, starting with priority sectors then on to others (in some cases questionnaires will be filed on the spot; in others they will need to be collected after one or two days);

(iv) data entry and validation;

(v) assignment of unique establishment identifiers;

(vi) conducting consistency and plausibility checks to ensure accuracy of reporting, and re-interviewing establishments if needed to obtain accurate information;

(vii) tabulation of benchmark results;

(viii) testing proposed questionnaires for annual and quarterly surveys; and

(ix) setting up computer programs for annual and quarterly surveys, and testing them.

13. This work is estimated to require an average of about two months in each state and about two months at the National office (to set up procedures for national accounts estimation), assuming the full-time participation of existing staff. The emphasis will be on ensuring that the staff are fully versed in the process, rather than on simply producing final results. Chuuk State is deemed to need extra full-time support, and a separate request is being made through the United Nations Development Programme (UNDP)/Suva to provide a United Nations Volunteer for two years.

E. Cost Estimates and Implementation Arrangements

14. The additional estimated budget costs given in Table 1 are based on the provisions of the current contract with the Boston Institute for Developing Economies (BIDE) for providing the services of EMPAT. BIDE will assign additional staff to EMPAT in consultation with the Bank, and agree on rates with the Bank for such staff in accordance with agreements included in the current contract.

15. An amount of $120,000 remains in TA No. 2294-FSM; an additional $540,000 is required to supplement the TA.

Table 1: Cost Estimates for Expansion of EMPAT
($)

Item	Cost
Third Adviser Salary/Benefits/Charges (13 months)	315,000
Short-term Consultant : Strengthening Monitoring of Policy Reform Impacts (10 months)	160,000
Travel for Third Adviser (international and domestic) and Increase for Resident Advisers (domestic)	60,000
Equipment (third adviser and local staff economists)	10,000
Communications (third adviser and increases for others)	20,000
Miscellaneous (housing, shipment)	15,000
Contingencies	80,000
Total	**660,000**

II. Investment Promotion and Financial Sector Review

A. Background

16. The financial sector in the FSM consists of (i) three commercial banks: the Bank of the FSM, the only domestically owned bank with offices in each State; and two foreign banks, the Bank of Guam with offices in Pohnpei and Chuuk, and the Bank of Hawaii with offices in Pohnpei, Kosrae, and Yap; (ii) the FSM Development Bank; (iii) six insurance companies; and (iv) four credit unions. Although the Banking Board was established in 1980 and is responsible for the supervision of banks, no prudential guidelines are being implemented. The Development Bank, the insurance companies, and the credit unions are currently neither licensed by the Banking Board nor subject to reporting requirements.

17. Financial depth, as measured by the total banking assets/gross domestic product (GDP) ratio of 86 percent, is not particularly low by developing country standards, but the declining trend of credit outstanding shows sluggish performance by the commercial banks. The total outstanding credit of commercial banks as of the end 1995 was $54 million (of which $21 million was in commercial loans) as against $30 million of FSM Development Bank. Although there exists a restriction on capital flows that banks should not transfer abroad more than 50 percent of deposits received from local residents, this regulation has not been enforced. In fact, more than 50 percent of the deposits held in commercial banks has been transferred to head offices or correspondent banks abroad. In addition to a lack of viable projects, a weak policy, legal, and regulatory framework and an inadequate market infrastructure are considered as causes of the low levels of lending of the commercial banks.

18. Despite recent efforts in strengthening staff skills assisted by the Bank's TA,[1] lending operations of the FSM Development Bank are weak, mainly due to concerns about future funding resources, a lack of commercial orientation, and a weak portfolio performance. The institutional weaknesses and required reform measures were partly elaborated in the Corporate Plan for 1996-2005 recently prepared assisted by the Bank's TA. To strengthen and implement the reform measures, the National Government needs to provide appropriate support for the reform process of the FSM Development Bank to enable it to be incorporated into the comprehensive reform framework for the financial sector.

19. To improve the investment climate, the National Government has been working on strengthening the legal framework, including revising foreign investment acts and land tenure acts, assisted by the EMPAT. In addition, the National Government will develop sector strategies on fishery, agriculture, and tourism especially to promote private sector activities, again assisted by proposed stand-alone Bank TA. At the State level, Pohnpei is in an advanced stage of private sector promotion compared with the other three States, with issuance of the Business Development Act of 1994. This created a Micronesian Entrepreneur Development Center (MEDC) and a loan guarantee scheme. In line with the Act, Pohnpei State operationalized a MEDC in 1994, and set aside $1.5 million from the State budget to operationalize the proposed loan guarantee scheme in 1997, assisted by UNDP. Chuuk State has also operationalized MEDC in 1996, while Kosrae and Yap are expected to follow, also

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[1] TA No. 2216-FSM: *Institutional Strengthening of the FSM Development Bank*, for $385,000, approved on 2 December 1994.

assisted by UNDP. Kosrae and Yap are interested in introducing a loan guarantee or similar scheme.

20. Nevertheless, sluggish investment activities and massive capital outflows are continuing due to the continuing structural weaknesses and to uncertainties after 2001. In encouraging private sector development under the PSRP, the Government has identified the weak financial sector and a lack of consistent investment promotion policy as key issues. Recognizing the need for a coherent strategy consisting of short- and medium-term, micro- and macro-level, and State- and National-level measures to improve the investment climate and financial sector performance, the Government requested Bank TA. The TA accompanying the proposed loan will assist the National Government in conducting nationwide reviews and preparing a coherent strategy on investment promotion and financial sector reform.

B. Objectives and Scope

21. The objectives of the TA are to (i) improve the private sector investment climate by developing a nationwide coherent investment promotion plan, and (ii) enhance commercial credit availability through reform measures.

22. The scope of the TA includes:

(i) preparation of a private sector investment promotion plan for the National Government that will include consideration of the establishment of an investment promotion agency, incentive measures for foreign investment, a venture capital fund, and a rural credit scheme;

(ii) review of the financial sector covering the financial institutions, the proposed loan guarantee scheme, and the Banking Board; and

(iii) review of the financial sector reform measures focusing on the institutional, legal, and regulatory framework; policy environment; market infrastructure; and other structural impediments .

C. Terms of Reference

1. Investment Promotion

23. The investment promotion policy expert will be recruited for 3 months to assist the Department of Resource and Development and other concerned departments of the National Government in developing a private sector investment promotion plan following legislative approval of the proposed Foreign Investment Act expected in early 1997. The investment promotion policy expert will liaise with EMPAT; the Foreign Investment Advisory Service (FIAS) of the International Finance Corporation, and UNDP consultants in collecting the required information. The terms of reference of the consultant will include, but will not be limited to, the following:

(i) Review all the study papers on private sector investment promotion policy prepared by EMPAT, FIAS, UNDP, and the National and State governments.

(ii) Review the Foreign Investment Act of the National Government and the draft implementation guidelines of the State governments.

(iii) Prepare an assessment paper on the comparative advantages of the productive and service sectors of the FSM in relation to neighboring countries, and on investment promotion and marketing strategies of other developing member countries (DMCs) with similar economic structure.

(iv) Prepare a review paper on ongoing National- and State-level private sector investment promotion plans.

(v) Prepare an issues/recommendation paper on a nationwide private sector investment promotion plan, including consideration of the establishment of an investment promotion agency, incentive measures for foreign investment, a venture capital fund, and a rural credit scheme.

(vi) Assist the National Government in developing an action plan for the proposed promotion policy, and prepare a report on the status of implementation of the plan.

(vii) Prepare a final report covering items (iii)-(vi).

2. Financial Sector Review

24. This component of the TA has two subcomponents: (i) a review of the financial sector, including the loan guarantee scheme to be implemented in Pohnpei State, and preparation of a recommendation paper on the proposed guarantee scheme or alternative measures for other State Governments; and (ii) a review of financial sector issues, and development of financial sector reform measures including the institutional strengthening of the FSM Development Bank and the Banking Board. A financial analyst (loan guarantee scheme expert) and a financial sector economist (banking expert) will be recruited for 3.5 person-months each. They will liaise with each other and with the concerned departments of the National and State governments, EMPAT, FSM Development Bank, Banking Board, an adviser from the International Monetary Fund, and UNDP consultants. The terms of reference of the consultants will include, but will not be limited to, the following:

(i) Financial Analyst (Loan Guarantee Scheme Expert)

(a) Prepare an assessment paper on the performance of the publicly funded loan guarantee scheme in general, including a comparative analysis of other DMCs' schemes.

(b) Prepare a review paper on the structure, implementation status, financial viability, and operational issues of the loan guarantee scheme to be implemented in Pohnpei State.

(c) Prepare a financial and portfolio performance assessment of financial institutions in each State including the three commercial banks, FSM Development Bank, six credit unions, and four insurance companies.

(d) Prepare a recommendation paper on the structure and implementation guidelines of the loan guarantee schemes or alternative measures for each State government.

(e) Prepare a final report covering items (a)-(d).

(ii) Financial Sector Economist (Banking Expert)

(a) Based on the assessment paper noted in para. 23(iii) and a sector analysis, prepare a paper highlighting financial sector issues, focusing on the institutional, legal, and regulatory framework; policy environment; market infrastructure; and other structural impediments.

(b) Prepare a recommendation paper on financial sector reform that will include proposals for the establishment of prudential guidelines, a loan guarantee scheme, a venture capital fund, a credit information bureau, a rural credit scheme, and required legislation.

(c) As an integral part of reform measures mentioned in (b) prepare recommendations for an action plan of the National Government to strengthen the FSM Development Bank and support its medium-term corporate plan.

(d) As an integral part of the reform measures mentioned in (b) prepare recommendations on the supervisory function of the Banking Board. Give consideration to the preparation of prudential guidelines, and an extension of the coverage on its supervision to the FSM Development Bank.

(e) Prepare a final report covering items (a)-(d).

D. Consulting Services

25. Three international consultants are required with experience and expertise in the Pacific region, comprising an investment promotion policy expert, a financial analyst (loan guarantee scheme expert), and a financial sector economist (banking expert). The consultants will require a total of about 10 person-months, including about 1.5 person-months (0.5 person-

month each) in the home office, to complete their work, with the expected distribution of their workload described below:

Table 2: Duration of Consulting Services for Investment Promotion and Financial Sector Review (months)

Expert	Fieldwork	Home Office	Total
Investment Promotion Policy Expert	2.5	0.5	3.0
Financial Analyst (Loan Guarantee Scheme Expert)	3.0	0.5	3.5
Financial Sector Economist (Banking Expert)	3.0	0.5	3.5
Total	8.5	1.5	10.0

E. Cost Estimates and Financing Plan

26. Total cost of the TA is estimated at $400,000, of which the Bank will finance $380,000 on a grant basis. The Government's contribution will be $20,000.

Table 3: Cost Estimates for Investment Promotion and Financial Sector Review ($ '000)

Item	Cost
A. Bank Financing	
1. Consultants (Remuneration and Per Diem)	310
2. Equipment and Computer	10
3. Communications / Reports	10
4. Contingencies	50
Subtotal	380
B. Government Financing of Office Accommodation and Support Services	20
Total	400

F. Implementation Arrangements

27. The Department of Resources and Development of the National Government will act as the Executing Agency (EA) for the TA. It will seek the full cooperation of other concerned departments of the National and State governments, Government institutions, and financial institutions, and will provide office space and logistical support. The consultants will submit to the EA and the Bank an inception report two weeks after the commencement of work. The draft final report will be submitted two weeks prior to completion of the study assignment, and will be discussed at a tripartite meeting attended by the Bank, EA, and the consultants prior to finalization.

POVERTY IMPACT ASSESSMENT

A. Introduction

1. The Bank recognizes that reform programs undertaken to strengthen the national economy can have adverse social consequences. The Bank is concerned that, should some sectors be affected, in particular the poor, the negative effects should at least be minimized. This appendix analyzes the impact of the Public Sector Reform Program (PSRP) using the Bank-recommended framework. It is based on an analysis of socioeconomic conditions in the Federated States of Micronesia (FSM).

B. Methodology

2. The first section presents the framework and some constraints. A definition of the poor is attempted in the absence of poverty measurements in the FSM, and a short economic profile of public servants is discussed in the context of poverty. Finally, the two scenarios to be used in the analysis are presented.

1. Framework of Analysis

3. The Bank's approach to the social/poverty impact analysis of program loans focuses on the economic impact of policy conditionalities on the poor. The framework evaluates the policy change effects on the poor through four channels: (i) the labor market or the demand (and supply) of unskilled labor; (ii) the commodity market, specifically through the prices of the goods the poor sell and buy; (iii) change in the transfer payments the poor receive or the taxes they pay; and (iv) their access to public (e.g., education) and other rationed (e.g., credit) goods and services. The reform effects are grouped into four categories: (i) direct (and immediate) effects on the poor; (ii) indirect (or second-round) effects on the poor; (iii) macroeconomic (or economy-wide) effects; and (iv) effects on the nonpoor who become poor as a consequence of policy changes, whether temporarily or permanently. The impact is then assessed for each condition (e.g., the direct effect on the poor of the tax reform through the level of demand for their unskilled labor), analyzing whether the policy will increase, decrease, or not affect the income of the poor, and whether the change is likely to be large or small, and, finally, capping the analysis with the overall net effect of these reforms.

4. While some policy actions may affect the poor to some extent, the PSRP's overall thrust is to strengthen the economy. Moreover, the PSRP consists of a whole package of reforms (not a single reform), the effects of which are not mutually exclusive, such that distinctions among categories (e.g., between indirect and macroeconomic effects) or across channels (e.g., price and labor) may not be strictly clear-cut. Furthermore, poverty is a result of multiple causes. An event such as the implementation of the PSRP may not wholly account for the improvement or deterioration in the situation of the poor.

5. The economic conditions under which these reforms will be implemented are summarized as follows: the existence of a dual economy (of a small monetized sector and a traditional subsistence sector) largely dependent on a high level of official transfer under the Compact of Free Association agreed upon between the United States and the FSM, and the

prevailing problem of two macroeconomic imbalances: a large fiscal deficit and a large external deficit. Briefly, the reforms cover reducing the size of government, improving domestic revenue generation through tax reforms, supporting the development of the private sector, and restructuring government enterprises. The bulk of the loan will be used for the upfront cost of an early retirement scheme to mitigate the impacts on "retiring" employees.

2. The Poor and/or Most Vulnerable Group

6. No poverty line (or the level of income below which individuals or families are considered poor) exists in the FSM. Income or expenditure data against which the poverty line could be compared to determine the number of poor individuals or families are rather limited. Applying the 1994 US poverty matrix (of $7,547 for single adults under the age of 65, $15,029 for a two-child family, etc.) to cash income recipients of the FSM in the 1994 national census produced poverty incidences of 91 and 93 percent for individuals and families, respectively. An unrealistically high incidence, these results underscore the need for appropriate definitions of poverty, and the importance of the barely captured subsistence sector in the dual nature of Micronesia's economy.

7. Based on studies of poverty, the truly poor come from large families with predominantly young members, with no major income earner or with unskilled earners, and with no access to land and capital. There are many types of poor, and gradations of poverty. They can be urban-based (living in or near the urban districts of main islands, where the modern sectors are concentrated) or rural-based (living in or around rural districts or remote islands with prevalent traditional sectors). In market economies, they work long hours and receive extremely low wages for their labor. They work in primary production, and in much of the so-called informal sectors creating their own employment. They benefit greatly from labor-intensive activities under rapid economic growth, and from access to education and health services.

8. With nearly two out of five households in the FSM engaged in home-production activities that allow them to provide food for themselves, and considering the communal nature of communities in the country, the number of the truly poor is on the low end. Most households own land but have used it mainly for home production. There are probably some poor in Yap, of the borderline type, due to the strong subsistence activities; and some in Kosrae since all land and beaches are private. In Pohnpei, most of the poor are likely to be urban-based engaged in the informal economy, while in Chuuk, they may be found in both the center and outer islands.

9. National and State public servants in the FSM whose incomes are the subject of cost-cutting measures are generally better off than the poor. The relatively high pay and job security together with the limited private sector employment opportunities have contributed to the high steady growth of the public sector. The 1994 census results show that almost one in every two persons in paid employment works for the government. National and State government employees are most likely to be high school and college graduates in a population where only 18.2 percent have reached this level of attainment. Moreover, their median incomes are 2-4 times the overall median income and double the median income in the private sector. One in every six employees receives some income other than from wages/salaries. Furthermore, in the households to which they belong, there is at least one other income earner

with less likelihood of being a government employee. The majority have access to land and home production. Due to the comparatively higher level of welfare they enjoy, some retirees may be considered as the nonpoor at risk of being somewhat poor rather than the truly poor.

3. Two Scenarios: With and Without Reform

10. The assessment uses two contrary actual scenarios to qualitatively analyze the impact of the reforms. Largely due to scarcity of reliable data, the Economic Management Policy Advisory Team (EMPAT) has done a "before and after" type of analysis from which some of the conclusions are drawn. Both scenarios assume a substantial drop in assistance by the end of the Compact period. The scenarios are shown in the two tables on pages 60 and 61.

11. The first scenario — with reform — assumes that (i) the reforms are carried out within the period specified, (ii) there are sufficient employees who will avail of the voluntary early retirement program, and (iii) the private sector and foreign investors respond favorably and immediately to reforms once impediments are removed and necessary incentives are in place.

12. The second scenario — without reform — assumes that no further reforms are instituted other than those implemented so far, i.e., current expenditure levels are maintained (freeze in hiring, no automatic step increase) and there is only a slight increase in export and tourism revenues.

C. Poverty Impact Assessment

13. Reforms are introduced to address difficulties, so it can be expected that some problems are likely to arise in the FSM. The retrenchment, freeze in wages, and public wage reduction, while reducing government spending, also reduce the income of people and with it their capacity to buy. Increases in existing taxes and imposition of new ones, while generating more revenue, further depress this capacity. Everyone in the FSM will experience these effects in varying degrees — those who will lose their jobs in both public and private sectors; those in the monetized economies who be affected more than those in subsistence; and the poor, who are more likely to be significantly affected than the nonpoor. The revenues that will be received by the government will diminish its reliance on Compact Funds. However, it will also increase the capacity of government to deliver basic services and, more importantly, to stimulate the economy. Thus, it becomes imperative to match the fiscal consolidation with a determination to increase the size and competitiveness of the productive sectors. Reforms are likely to be difficult under slow growth, causing the poor to suffer more. The scenarios show that reforms cannot be avoided, and that they should be done now in a managed fashion rather than under crisis.

1. Policies with Potential Impact on the Poor

14. Among the reforms, the one that has the most potential positive impact on the poor is the development of the private sector through a return to full employment. The industries to be developed under the PSRP — agriculture, fishery, and tourism — are labor-

intensive, which will generate the needed jobs. The infrastructure requirements (power, roads) will increase demand for their labor. They are likely to be employed for a longer period. The training programs could also be focused on skills development of dropouts, who cannot afford higher education. Education can be reoriented toward appreciation and practice of good work attitudes.

15. Streamlining of operations and restructuring of government enterprises have both positive and negative impacts. The positive impact will come in the form of improved efficiency in the delivery of basic services, increasing both coverage and quality. The shift of priority (e.g., from curative to preventive) will also produce the same effect. The negative impact will be brought about by job losses. Increase in unemployment will affect the poor, whether directly or indirectly.

16. Tax reforms will have an adverse impact on the poor. Imposing user charges will limit their access to certain goods and services, some of which used to be free. Import taxes on petroleum and, in particular, food will have a wide-ranging negative impact. The existing lifestyle has bred dependence on imported goods.

2. Economic Impact of Reforms

17. **Direct impact.** Under the without-reform scenario, the demand for labor of the poor is very limited and will be expected to continue in the medium term, while the Public Sector Investment Program component of the reform, specifically its infrastructure activities, will increase this demand. The poor will need to pay more for the goods they buy in both the with- and without-reform scenarios, but possibly with steeper prices under the latter condition. However, with these increases, some increase in the demand for the goods they sell will occur. No improvement in terms of access is expected under the without-reform scenario, since the sources of such funds are declining, while user charges under the with-reform scenario may limit access to certain services. Under both scenarios, subsidies of utilities are eliminated. The extent of effects will be determined largely by usage level. For the poor, the effect may be marginal, as most of their housing units still have no piped water or electricity.

18. **Indirect Impact.** Job losses in the private and public sectors will happen under the with-reform scenario. While this will also happen under the without-reform scenario, unemployment will possibly be widespread. This will be abated under the with-reform scenario by the development of the private sector, which will open up new employment opportunities. While an increase in the coverage and quality of basic services under the with-reform scenario can be expected, under the without-reform scenario budgetary constraints will hamper the government's capacity to deliver these services, resulting in further deterioration.

19. **Macroeconomic Impact.** Personnel reduction in the public sector, subsidy elimination, and revenue increases from tax will reduce the government's fiscal deficit under the with-reform scenario. Moreover, an increase in unemployment rates is expected at the outset. Additional revenues will be used to reduce external imbalance through direct and indirect incentives to exports. Under the without-reform scenario, the same reforms will be resorted to in the medium term and under severe constraints.

20. **Impact on the Nonpoor.** The nonpoor will be able to cope under both scenarios, amid price increases and elimination of subsidies, due to their acquired skills. However, under without-reform scenario, the nonpoor will have very limited options, lengthening their state of poverty, and will most likely be encouraged to migrate. Under the with-reform scenario, the nonpoor will have more options including training programs and credit to start a business.

3. Non-economic Impact of Reforms

21. The success of the economic reforms is envisioned to lead to broad-based high growth in production and to rising incomes and employment. The last two are widely assumed to have beneficial consequences on well-being. Higher incomes are pursued because potentially they can support consumption of commodities of better quality and variety, and may be used to invest in education and health. Similarly, a government not saddled with large deficits and inefficient machinery should be able to provide quality basic services to its constituents.

22. An assessment of the secondary social consequences under the with-reform and without-reform scenarios is presented in Table 1. These are analyzed in the medium term, since reforms have lag effects.

Table 1: Social Consequences of Reforms

	Scenario	
Indicator	**With reform**	**Without reform**
Life expectancy	N	-
Infant mortality rate	N	--
Maternal mortality	N	-
Child mortality rate	N	-
Child malnutrition	N	-
Access to safe water	N	-
Access to health care	N	--
Adult literacy	N	N
Enrollment ratios	N	--
School dropout/survival rates	N	--

a N = positive or neutral effect, - = moderate negative effect, -- = severe negative effect.

4. Mitigating Measures

23. There is no known formula to determine just how big a government should be at any one point. The PSRP include is the formation of joint executive-legislative restructuring and reform committees that will determine realistic and sustainable staffing needs. The

mechanics of implementing the early retirement scheme (ERS) is still being refined, rendering analysis, in terms of the actual size of personnel reduction, prospective. To make the exercise more objective, the EMPAT has set up a database of government activities from which employee full-time equivalents (FTEs) are derived. Activities are further classified as to those in which the public sector should be involved, those that can be divested to the private sector, and those that can be discontinued. About 25 percent of FTE activities will be out of government responsibility from end-1996 to mid-1999.

24. The voluntary characteristic of the retirement process allows room for flexibility. The PSRP encourages employees in the age group 55 years and over to avail of the ERS with provisions for annuity equivalent to the social security pension payable until age 60. With their long years of service, they have likely accumulated some assets and cash reserves. Those with loans acquired during their tenure might not find leaving the service a good option. The more likely to avail of the scheme are those who can see opportunities of alternative employment, as entrepreneurs or in the private sector. Experience with other countries under rapid economic growth shows that, when an ERS is voluntary, those in higher positions with good qualifications are the ones who avail of such schemes. When the necessary investment incentives have been put in place and with government wages/salaries and other benefits reduced under the PSRP, staying in government will become less and less attractive. The voluntary nature of the scheme, implemented within a reasonable length of time and with adequate compensatory measures, diminishes the harsh realities of retrenchment somewhat.

25. The compensatory measures acknowledge that, in the short term, it is highly unlikely that the private sector will be able to absorb those who will opt to retire. The following are the compensatory packages being offered. For Yap: a lump sum of up to 2 years of salary not subject to any condition of training or entrepreneurial proposals; Chuuk: (i) a lump sum of up to 20 months of pay linked to training or business loan proposal; (ii) biweekly payments for 2 years (declining over time); or (iii) a combination of 10-month lump sum and biweekly payments for a year; Pohnpei: (i) lumpsum payment, or (ii) biweekly payments: Kosrae similar to Pohnpei, plus the reintroduction of the compulsory retirement at 55 (currently optional) with provisions for annuity equivalent to the social security pension payable until the recipient becomes eligible.

26. In addition to these, employee outplacement services will be provided and skill-upgrading training programs are being developed.

IMPACT OF THE FSM PUBLIC SECTOR REFORM PROGRAM
Scenario 1: With Reforms

Channel\Effects	Direct	Indirect	Macro- or economy-wide	Nonpoor at risk of being poor
Labor market	In the short term, when unemployment is highest, the poor will rely mostly on their "entrepreneurial" options (informal sector). However, the Public Sector Investment Program (PSIP) component of the reform, i.e., the infrastructure activities will increase the demand for their labor.	In the short term, job losses of more educated/skilled workers will lessen demand for their labor. However, in the medium term, private sector development in agriculture, fishery, and tourism industries, which are labor-intensive, will increase the demand.	In the short term, reducing the size of government (shedding excess labor) will arrest its enlarging fiscal deficit. Increase in unemployment rate will occur. In the short to medium term, when impediments to investment have been removed, infrastructure and export incentives have encouraged the productive sectors- agriculture, fishery, tourism - there will be full employment production and rapid growth.	State and National Government public servants who will avail of the ERS will (i) opt to migrate, in which case there will be less skilled/professional labor in the manpower pool; (ii) invest in a small business; or (iii) remain unemployed (do subsistence or gain new skills) under the program until improved economic conditions give rise to new employment opportunities. (They have educational mobility; hence, this is temporary poverty.)
Prices	There will be marginal increase in the goods/services they sell (local goods) due to a shift to substitutable (local) products (because of the high prices of imported goods). But they will suffer from the increase in prices of the goods they buy especially for their 'capital'.	Taxes will raise prices and will increase transportation costs (boat fuel). The increasing price of imported goods will cause a shift to locally-produced goods. The prices of local goods will increase in response to increase in demand.	During the reform process, prices become the mechanism to achieve certain effects. Imposition of/increase in taxes (e.g. import tax) will increase prices of goods, which will increase substitution needed to stimulate productive sectors. While it will address the deficit problem, by revenue increase, it will also address external imbalances, eventually leading to growth.	The nonpoor at risk of being poor will be affected by price increases and will respond accordingly (modify behavior, increase income-generating activities) but they will be better able to cope than the truly poor.
Access to public/rationed goods (education, credit)	User charges on health will limit access of poor. HRD in PSIP, if focused on those who drop out of school because they cannot afford to continue studying, will improve the economic situation of the poor.	The government's policy shift from curative to preventive treatment in health and the PSIP in education will improve coverage (and quality) of service.	Increased efficiency in the delivery of basic services will increase access and equitable distribution of basic services. This may reduce the incidence of poverty for those nearer the "line". There will be less drain on resources from referrals.	Increasing availability of finance to small entrepreneurs by instituting a loan guarantee program will shorten length of their temporary poverty.
Transfers (/Subsidies)	During the reform process, the poor will suffer from elimination of subsidies as they cope with price increases. (The extent will be determined by usage. Many still have no water or electricity in housing units.)	Removal of subsidies and privatization of utilities (or transfer to other service providers) will increase efficiency and be accessible at lower cost.	Less subsidies/transfer means lower fiscal deficit.	They will have more means to cope with elimination of subsidies.
Total Net Effect	In the short term, it will be difficult for the poor unless the private sector grows quickly. The medium-term effects are more favorable for the poor.			
Assumptions	(1) The reforms are carried out within the period specified. (2) There are sufficient employees who will avail of the Early Retirement Scheme. (3) The private sector and foreign investors respond favorably to reforms given the removal of impediments.			

IMPACT OF THE FSM PUBLIC SECTOR REFORM PROGRAM
Scenario 2: Without Reforms

Channel\Effects	Direct	Indirect	Macro- or economy-wide	Nonpoor at risk of being poor
Labor market	Minor.	In the medium term, widespread unemployment will further decrease/limit the demand for unskilled labor.	In the medium term, the fiscal deficit will be unsustainable, causing drastic cuts in government spending, including personnel cutback. In the short term, no significant decrease in unemployment rates will occur in the formal sector since limited private sector, development will occur.	Government will be unable to provide adequate severance pay and other mitigating measures.
Prices	The poor will suffer from sharp price increases. There will be a marginal increase in demand for goods sold	Price of some imports will rise due to scarcity, and there will be a shift to substitutable products.	In the medium-term, the large external deficit will become unsustainable and cause reduction in imports. Drastic revenue-generating measures will be implemented, causing sharp increase in prices.	The nonpoor will be able to adjust.
Access to public/ rationed goods (education, credit)	In the short term, there will be no improvement in access.	In the medium term, deterioration in infrastructure and delivery of basic services will mean less access for the poor.	In the medium term, the unsustainable fiscal deficit will hamper the government's capacity to deliver basic services.	Credit will be inaccessible due to increased demand
Transfers (/Subsidies)	During the reform process, the poor will suffer from elimination of subsidies as they cope with price increases. (The extent will be determined by usage. Many still have no water or electricity in housing units.)	Removal of subsidies and privatization of utilities (or transfer to other service providers) will increase efficiency and be accessible at lower cost.	Lower subsidies/transfers mean lower fiscal deficit.	They will have more means to cope with elimination of subsidies.
Total Net Effect	In the short term, there will be little improvement for the poor. In the medium term, the poor will face more hardship.			
Assumption	Current levels of expenditures are maintained and there will be no increase in domestic revenue, except minimally from tourism.			