

The Government of the United States of America

# First Five-Year Review of the Compact of Free Association, As Amended, Between the Governments of the United States and the Federated States of Micronesia

Report to the Congress of the United States of America

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## **EXECUTIVE SUMMARY**

### **Purpose of the Report**

This report reviews the terms of the Compact of Free Association between the Government of the United States (U.S.) and the Government of the Federated States of Micronesia (FSM) as required by Section 104(h)(2) of Public Law 108-188, the Compacts of Free Association Amendments Act of 2003 (Amended Compact). The law states that the review is to occur during the year of the fifth, tenth and fifteenth anniversaries of its enactment. The Amended Compact was enacted on December 17, 2003. The fifth year of implementation ended in FY 2008 on September 30, 2008.

The report addresses the overall nature of the relationship between the U.S. and the FSM; describes the general social, political and economic conditions of the FSM, including estimates of economic growth, per capita income and immigration rates; and assesses progress made in the following areas:

- The use and effectiveness of United States financial, program and technical assistance;
- The status of economic policy reforms including but not limited to progress toward establishing self-sufficient tax rates;
- The status of efforts to increase investment including, the rate of infrastructure investment of U.S. financial assistance under the Amended Compacts, non-U.S. contributions to the FSM trust fund, and the level of private investment; and
- The report considers the operating requirements of the FSM in meeting its strategic development objectives and offer recommendations on ways to increase the effectiveness of United States assistance.

### **Summary of Findings and Recommendations**

The FSM is in a fragile fiscal condition from the effects of the recent worldwide recession, inflation, investment decisions and the timing of annual decreases in annual Compact grant assistance. A large public sector dominated the economy while the private sector was small and operated in an environment often unfriendly to foreign investment. Weak internal fiscal policies and sluggish progress in instituting necessary tax and other reforms also contributed to the situation.

FY 2004 through FY 2008 was a difficult period of adjustment to the new terms and conditions for financial assistance under the Amended Compact. Challenges with communication and coordination between the FSM national government and the states were barriers to the implementation of the Amended Compact during the five-year reporting period, resulting in the submission of late financial and performance reports or none at all. Financial and performance reporting did not meet the letter and spirit of the Amended Compact and its subsidiary Fiscal

Procedures Agreement. Annual budgets generally lacked specific performance objectives, priorities, and targets that linked back to the FSM's Strategic Development Plan (SDP).

At the end of the reporting period, Infrastructure funds remained unspent because of management issues and difficulty in setting priorities for capital investment that took the interests of the nation into consideration rather than the parochial interests of individual states. Land titling problems that existed before the Amended Compact remained unresolved. While there was some improvement in educational and health outcomes, there need to be better results within these sectors.

Development planning, budgeting practices, and performance monitoring by the FSM did not meet the new accountability regimen required by the Amended Compact. Processes and tools need improvement and plans need to be reviewed and updated to be useful. Most significantly, the FSM has not planned ahead for the impact that Compact-mandated decreases in annual financial assistance would have on the Amended Compact's three priority sectors and for support for private sector development, improving the human environment, building capacity in management, accounting, and other areas critical to effective FSM governance.

The Amended Compact sets forth a process for collaborative management of annual allocations and related policy decision-making by the U.S. and the FSM through the Joint Economic Management Committee (JEMCO). It is primarily to that body that this review addresses recommendations to improve the use and effectiveness annual assistance from the United States.

### **Recommendations:**

1. The bilateral JEMCO should aid the FSM in planning for the annual decreases in grant assistance, especially with regard to the priority sectors of education, health, and public sector infrastructure development.
2. The FSM and United States should actively seek third-party donors and collaborate in examining the projected income from the Trust Fund for the People of the Federated States of Micronesia after 2023, and explore options that may assist the Fund to increase its projected value within the bounds of acceptable risk.
3. JEMCO should adopt allocation policies and grant conditions that ensure maximum benefit in the sectors of education, health, infrastructure maintenance, environment, private sector development and public sector capacity building.
4. JEMCO and the FSM national and state governments should ensure that annual sector grant allocations follow a well-defined annual budget plan developed by the FSM that has specific annual performance targets that link to the country's Strategic Development Plan and in the case of infrastructure development, to the country's Infrastructure Development Plan.



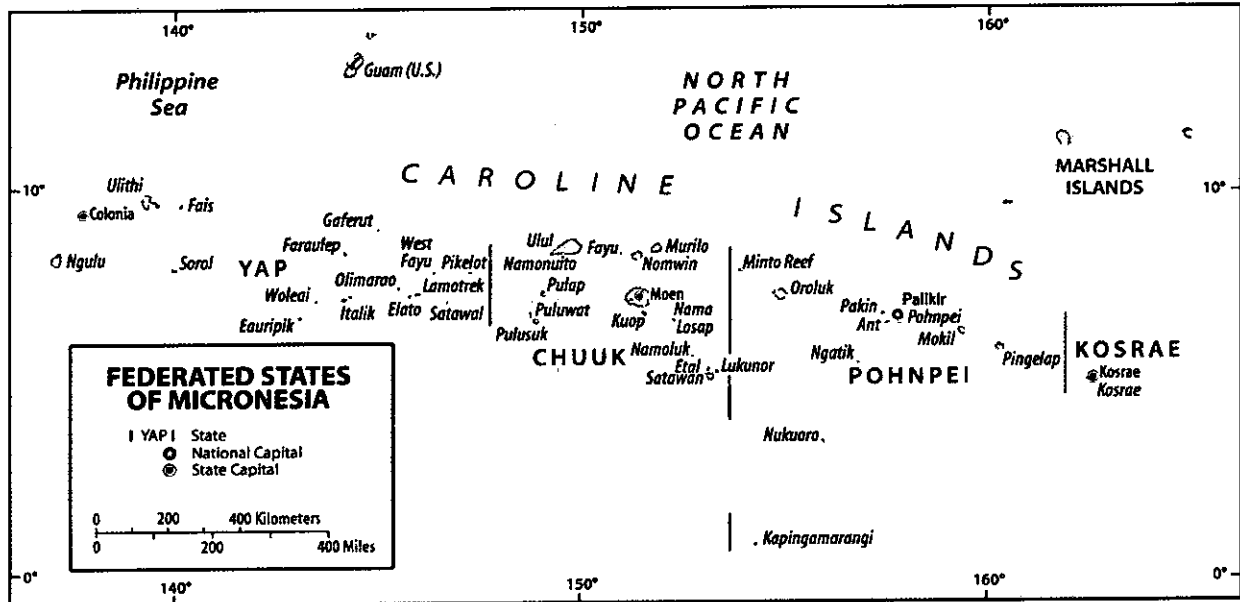
5. JEMCO should bring substantial and sustained pressure for FSM action on critical economic and financial issues and reform strategies necessary to promote private sector development, including:
  - Reform of FSM national and state tax laws to encourage domestic and foreign private investment and increase government revenue and fiscal stability;
  - Correct land title and land lease problems that hobble capital investment in both public sector infrastructure development with U.S. Amended Compact funding and private sector investment;
  - Encourage the FSM national government and all four states (especially Chuuk and Pohnpei) to adopt consistent direct foreign investment laws that will help the private sector grow;
  - Plan for an orderly reduction in public sector employment in response to the coming decreases in Compact funding and to make room for private sector development;
  - Act on the 2001 Aries Report for reform of public utility functions, ownership and rates to ensure the reliability of power, potable water, communications and wastewater management;
  - Identify public infrastructure needs, design and construction; and
  - Institute regular economic planning and statistical analyses by the FSM national and state governments for setting priorities and making policy decisions.
6. JEMCO should find ways, within its capacity to manage allocations and allocation policies, to encourage the FSM's implementation of comprehensive sector-wide public enterprise reform efforts, including privatization of government owned enterprises and the elimination of inefficient governmental subsidies.
7. JEMCO should require an updated comprehensive infrastructure development plan for health and education facilities that specifically incorporates a baseline investment by the FSM for maintenance.
8. JEMCO should take steps to ensure that FSM's basic education sector grant and SEG assistance primarily support the improvement of the country's basic education system and focus on direct classroom instruction, and that unrealistic expectations for assistance beyond the provision of basic education are curbed.
9. The FSM should request, and the JEMCO should allocate, more public sector capacity building assistance so that there is, for example, sufficient in-country expertise to generate economic and other data and statistical reports. In the case of capacity building in education and health, JEMCO should ensure that sufficient annual grant funding is earmarked to improve data, planning, and policy analysis competencies.

10. The United States should continue to provide technical assistance when the FSM articulates critical needs that cannot be addressed through the annual grant assistance process.

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## ASSISTANCE FRAMEWORK OF THE COMPACT

### Profile of the Federated States of Micronesia



The Federated States of Micronesia (FSM) is a sovereign country comprised of 607 small islands spread over more than one million square miles of ocean in the Western Pacific. Only 67 of the islands are inhabited. Total land mass area is small, amounting to 270.8 square miles, with only 6 percent of the land arable.

The FSM lies approximately 2,500 miles southwest of Hawaii. The other two Compact of Free Association nations are its closest neighbors, Marshall Islands to the northeast and Palau to the west. North of the FSM lie the United States territories of Guam and the Northern Mariana Islands.

The FSM has a population of 107,008<sup>1</sup> and four states, each of which includes a main island as well as dozens of smaller islands:

- **Chuuk State**, formerly known as "Truk," is the most populous of the FSM states, with almost half of the FSM's population. Twenty-five percent of Chuuk's population resides in the outer islands scattered to the north, southwest, and west. The majority of Chuuk's population resides in the Chuuk Lagoon which consists of 10 islands and Weno, the state capital. Altogether, Chuuk has 290 islands with a total land area of 49.2 square miles. Chuuk lagoon, world famous as a diving spot to explore Japanese sunken ships from World War II, is the largest in the FSM.

<sup>1</sup> FSM Census, 2000

- **Kosrae State**, essentially a single island surrounded by a fringing reef, has a total land area of 43 square miles. Approximately 8 percent of the nation's population resides in Kosrae.
- **Yap State** is home to 11 percent of FSM's population. It consists of four volcanic islands plus 19 inhabited outer islands and atolls with a total land area of 46 square miles. Of the three states who all maintain distinct cultural differences between the outer islands and the main island or main lagoon, this is most pronounced in Yap.
- **Pohnpei State** is the national capital of the FSM and the most developed among the four FSM states. The State consists of one large volcanic island and six inhabited atolls, with most of its 133 square miles on Pohnpei Island. Approximately a third of the country's population lives in Pohnpei State. The FSM's capital is located at Palikir. The U.S., Japan, China and Australia all have resident embassies in its capital.

The FSM's population is predominately Micronesian and comprised of eight major ethno-linguistic groups and numerous spoken dialects. Each state has its own languages, culture, local government, and traditional systems. With such diversity, English is the country's official language of government (although less so at the state or municipal levels), and for secondary and tertiary education. Communal values influence politics, daily business and personal transactions in both direct and indirect ways.

Twenty-two percent (22%) of all inhabitants live in "urban" town areas but may own property elsewhere in their respective states. Land is part of family trusts that pass down land use rights, surface and subsurface, from generation to generation within the extended matrilineal family system. Clans hold many parcels, leading to fractional ownership and uncertain boundaries and titles. By Constitution, only citizens can own land. Domestic corporations that have non-citizen shareholders may not own land.

The Constitution of the FSM provides for three separate branches of government at the national level similar to those of the U.S. The National Congress, however, is unicameral. It has four at-large senators, one from each state that serves four years, and ten (10) senators who have two-year terms. The President and Vice President are senators at-large elected by Congress rather than by popular vote. The last Congressional election for four-year terms was in March 2007. On May 11, 2007, the 15<sup>th</sup> FSM Congress elected Chuuk's Emanuel (Manny) Mori to be the seventh President of the Federated States of Micronesia. On May 10, 2011 Mori was re-elected for a second 4-year term.

The nation itself is a loose federation. State affiliation tends to overshadow national identity. The FSM Constitution limits the FSM national government's (executive branch) power and confers "residual powers" to the states, necessitating a complex and lengthy consultative process before the implementation of new national policies, regulations and programs.

The FSM has no military of its own, although its citizens do serve in disproportionate numbers in the U.S. Armed Forces. Under the Compact, the United States is obligated to "defend the Federated State of Micronesia and its people from attack or threats thereof as the United States and its citizens are defended." The United States maintains no military presence in the FSM. Given its location, the FSM will continue to be of strategic importance.

## **Periods of U.S. Assistance**

### **Pre-Compact of Free Association**

The relationship between the U.S. and Micronesia began during WWII with the liberation of the islands from Japanese occupation. The islands became a post-WW II strategic protectorate of the United Nations (UN) and three of six Trust Territory of the Pacific Islands (TTPI) districts administered by the U.S. starting in 1947. (Kosrae was part of the Pohnpei district). Initially under Navy control, TTPI administration transferred to the U.S. Department of the Interior in 1951 to oversee the advancement of local governance. U.S. operational support and technical assistance, economic development aid as well as promoting the growth of democratic institutions and the development of education and health systems closely modeled after the U.S., were the hallmarks of this period.

The U.S. created the Congress of Micronesia in 1965 to prepare the TTPI districts for greater self-governance. In 1979, the U.S. notified the United Nations that it had fulfilled its trust responsibilities.

Chuuk, Yap, Pohnpei and Kosrae ratified a new constitution to become the Federated States of Micronesia on May 10, 1979. The Honorable Tosiwo Nakayama, the former President of the Congress of Micronesia who hailed from Chuuk, became the country's first president. After lengthy negotiations, the FSM signed a Compact of Free Association with the U.S. that entered into force on November 3, 1986, officially marking Micronesia's emergence from trusteeship to independence.

### **The Compact of Free Association**

The original Compact of Free Association (Compact) between the U.S. and the FSM went into effect in 1986, after the passage of Public Law 99-239. The Compact granted self-governance to the FSM and established the framework for the advancement of that self-governance and for the governmental relationship between the U.S. and FSM that would follow. While the Compact itself carries on in perpetuity unless abrogated by one of the parties, certain specific financial and program assistance provisions set forth in Title II of the Compact terminated after fifteen years.

Under the original Compact, and continued under the Amended Compact, the U.S. allows FSM citizens to “lawfully engage in occupations, and establish residence as non-immigrant[s]” in the U.S., provides economic and financial assistance, and defends the FSM’s territorial integrity. In return, the FSM provides the United States with unlimited and exclusive access to its land and waterways for military purposes.

### The Compact’s First Direct Financial Assistance Period: FY 1987 – FY 2003

The Compact’s first financial assistance package lasted fifteen years, from 1987 to 2001, and was followed by two transition years of support through September 30, 2003.

Over the term of the Compact’s first financial package and the two ensuing transition years, the FSM received a total of approximately \$1.35 billion. Annual amounts included earmarks for infrastructure development projects and smaller allocations for health, education, and off-island medical referrals. Non-earmarked U.S. Compact assistance supported debt payments and targeted economic development sectors such as energy and communications, but most of the funding went to cover the general recurring expenses of the government with few controls or restrictions.

U.S. direct payments accounted for approximately 80 percent of all Federal funds going to the FSM. Assistance through the extension of Federal programs, services, and categorical and competitive grants accounted for the balance.

### The Amended Compact: FY 2004 – FY 2023

In 2001, the U.S. concluded that the political and security objectives of the Compact were met; however, it deemed that continued assistance was necessary because economic progress from 1987 onward had been disappointing. Chief among the reasons were: (1) the FSM was small, remote, resource-poor and lacked development opportunities; (2) U.S. funding given to the FSM contained few safeguards to ensure effective spending; (3) the FSM lacked full planning and management capacity; and (4) both education and health care had major shortcomings.

U.S. objectives were to maintain U.S. security interests, provide annual assistance to maintain economic stability and essential services, and move the FSM to greater economic self-reliance to complete the transition from dependence on U.S. financial assistance. Toward that end, the FSM and the U.S. agreed to the following terms (not all-inclusive but intended to highlight the provisions closely associated with this report):

- Beginning in FY 2004, the FSM would receive \$92.7 million annually. The amount includes \$76.7 million in annual grants to select areas rather than general government operations, and \$16 million for a trust fund established for the FSM. Language of the Amended Compact conditioned the U.S. contribution to the Trust Fund on the FSM’s deposit of at least \$30 million prior to September 30, 2004.

- Annual inflation adjustments would continue at 2/3 of the U.S. Gross Domestic Product Implicit Price Deflator, using FY 2004 as the baseline for calculations. Beginning in FY 2005, the annual inflation adjustment would use a percentage change formula specified by the Amended Compact. Funds arising from the adjustments would be available for allocation to targeted annual grants.
- Beginning in FY 2007, the FSM base grant would decrease by \$800,000 annually through FY 2023. This decrease would be added to the annual U.S. payment into the FSM Trust Fund. The trust fund arrangement was set up with the purpose of contributing to the economic advancement and long-term budgetary self-reliance of the FSM by providing an annual source of revenue beginning in FY 2024.
- Compact assistance would tie to specific outcomes and purposes, and be monitored primarily by the U.S. Department of the Interior's Office of Insular Affairs. Different from the first period of assistance, new fiscal and financial accountability provisions were included. These included, among others, more frequent and detailed reporting. Any misuse of funds could subsequently lead to the withholding of funds or other remedies that could be applied by the U.S. until the problem is resolved.
- A joint U.S. and FSM committee (Joint Economic Management Committee or JEMCO) would be created to approve annual allocations and performance objectives, strengthen management and accountability and promote the effective use of United States funding under the Amended Compact.
- The FSM would continue to be eligible for U.S. domestic grant programs, as authorized by the Congress. Several existing U.S. Federal education programs were recreated as the Supplemental Education Grant (SEG) and offered to the FSM. Moreover, the FSM would receive assistance from other agencies such as the National Oceanic and Atmospheric Administration, the Department of Agriculture, Department of Education.

The United States and the FSM signed the Amended Compact on May 14, 2003. The U.S. Congress passed the Compact of Free Association Amendments Act of 2003 on November 19, 2003, which the President signed into law (PL 108-188) on December 17, 2003.

## **New Fiscal and Financial Accountability Framework**

### **From General Operational Support to Assistance to Select Sectors**

Integral to the Amended Compact which operates under a new fiscal and financial accountability framework is the Fiscal Procedures Agreement (FPA). Negotiated and agreed to

by the FSM and U.S. as a subsidiary agreement to the Amended Compact, the FPA governs the grant process and sets forth detailed accountability procedures.

The Amended Compact specifies and defines six government sectors eligible for grant assistance. U.S. funding for each area is available according to the strategic development framework (plan) of the FSM. The sectors are:

- EDUCATION

Annual grants are available to support and improve FSM's educational system, and to develop the human, financial and material resources needed to deliver services and programs.

The FPA emphasizes: (1) advancing a quality basic education system according to performance standards appropriate for FSM; (2) providing secondary education or vocational training to qualified students; (3) improving management and accountability within the educational system; and (4) improving the relevance of education to the needs of the economy.

- HEALTH

Annual grants are available to support and improve the delivery of preventive, curative and environmental care (environmental health services such as sanitation), and develop the human, financial and material resources needed to perform these services.

The FPA gives priority to establishing sustainable funding mechanisms for: (1) operating a community-based system of prevention, primary care, mental health and substance abuse prevention, and (2) operating hospitals to provide appropriate levels of secondary care and reduce the reliance on out-of-country tertiary medical referrals.

- PRIVATE SECTOR DEVELOPMENT

Annual grants are available to support FSM's efforts to attract foreign investment and increase indigenous business activity by "vitalizing the commercial environment; ensuring fair and equitable application of the law; promoting adherence to core labor standards; maintaining progress toward privatization of state-owned and partially state-owned enterprises (SOE); and engaging in other reforms."

Funding priority is given to activities that: (1) advance the development of fisheries, tourism and agriculture; (2) employ new telecommunication technologies; and (3) analyze and develop new systems, laws, regulations and policies that foster private sector development and investment; and (3) develop business and entrepreneurial skills.



- PUBLIC SECTOR CAPACITY BUILDING

Annual grants are available to support FSM's efforts to build effective, accountable and transparent national and local government and other public sector institutions and systems.

The FPA gives emphasis to: (1) improving economic planning, financial management, auditing, law enforcement, immigration controls and the judiciary, and (2) compiling and analyzing appropriate statistical indicators. The goal of sector funding is to ensure the conduct of essential functions with positions filled by qualified candidates.

- ENVIRONMENT

Grants are available annually to support the Government of the FSM's efforts to increase environmental protection; establish and manage conservation areas; engage in environmental infrastructure planning, design, construction and operation; and involve FSM citizens in conserving their country's natural resources.

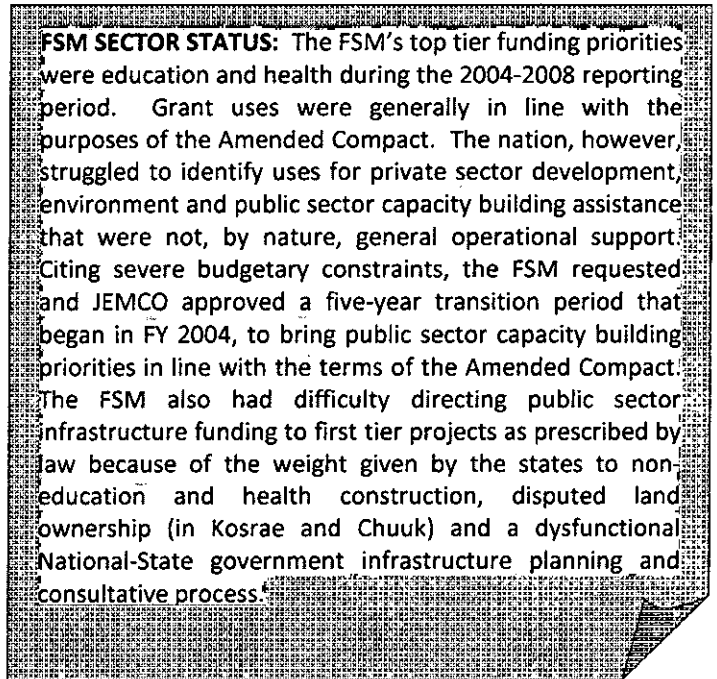
- PUBLIC SECTOR INFRASTRUCTURE DEVELOPMENT

Annual grants are available to assist the FSM in its efforts to provide adequate public infrastructure. Highest priority is on primary and secondary education capital projects and projects that directly affect health and safety. Secondary priority is given to economic development-related projects.

Five percent of the annual grant amount is set aside, with FSM matching the sum, for an infrastructure maintenance fund. While the Amended Compact does not specify a percentage of total U.S. Compact assistance funding that should go to infrastructure development, the sense of Congress in Section 104(g) of P.L. 108-188 reads that the amount "not be less than 30 percent."

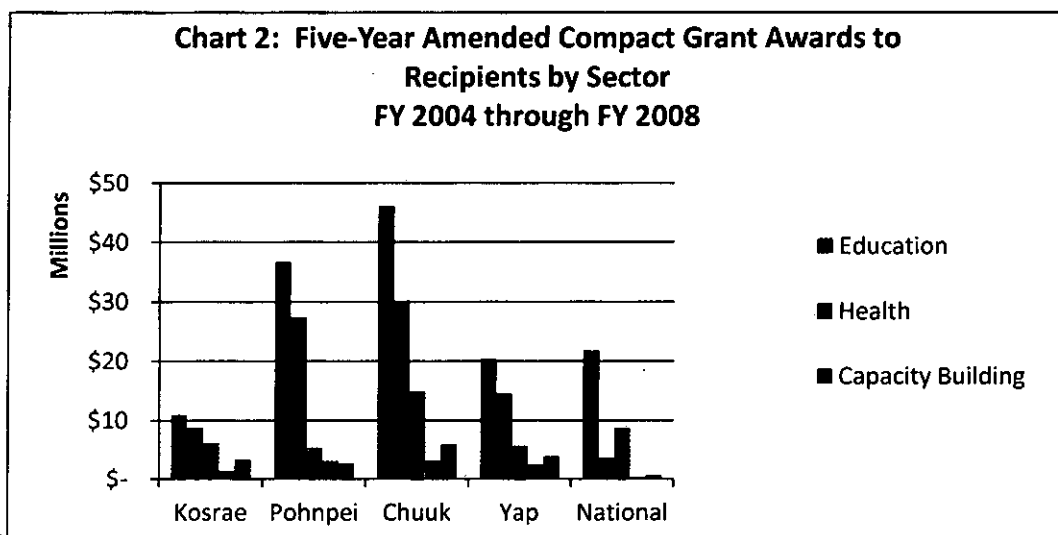
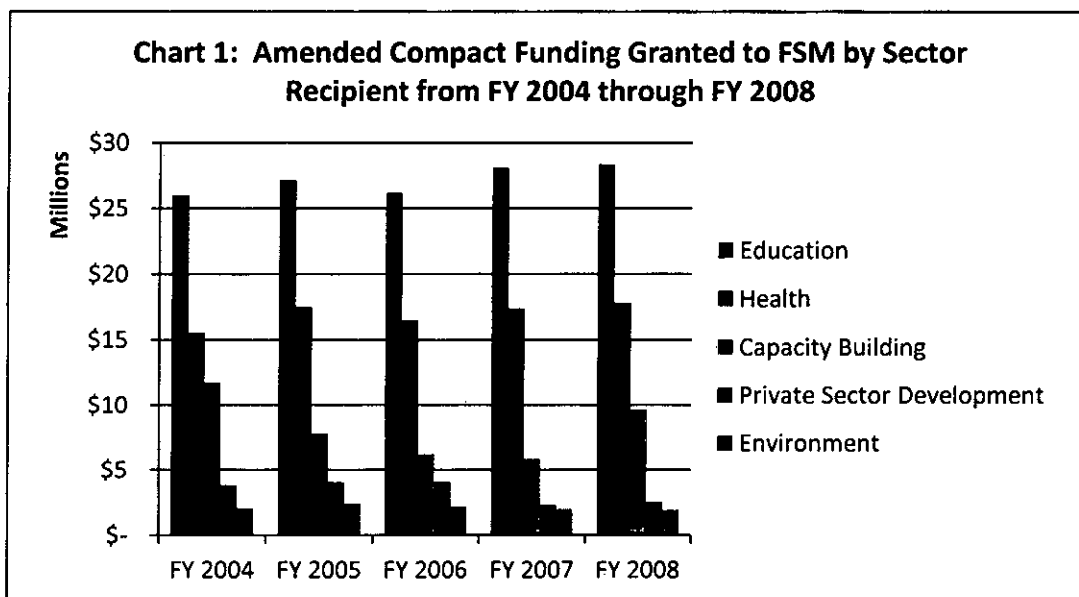
The top three annual priorities for U.S. Compact funding are the education and health sectors, and public sector infrastructure development, not necessarily in that order.

Other Amended Compact-funded areas include: (a) access to humanitarian assistance (HAFSM) teams from the U.S. military, as requested by the FSM and funded by Compact grants for health



and education infrastructure projects and for capital improvement projects that directly affect health and safety; and (b) disaster assistance through the establishment of a Disaster Assistance Emergency Fund (DAEF) consisting of matching U.S. and FSM annual contributions of \$200,000 to be used for assistance and rehabilitation needs resulting from disasters and emergencies.

The following charts show the U.S. Compact funding amounts received by the FSM from FY 2004 to FY 2008. The first chart displays annual grant funding to FSM recipients (states and FSM national government) by five sectors: education, health, and public sector capacity building, environment, and private sector development. It does not include public sector infrastructure development as capital development funding flows by project and not as a general annual allotment to the FSM. The second chart shows the five-year Amended Compact allocation totals awarded to Kosrae, Pohnpei, Chuuk, Yap, and the FSM national government for the same five sector grants.



## From Direct Payments to Annual Grants

From FY 2004 through FY 2008, Kosrae received \$25,562,250 in Amended Compact grant assistance; Pohnpei, \$70,302,220; Chuuk, \$86,813,111; Yap, \$42,856,843; and the FSM national government, \$26,725,860.

Whereas there were few restrictions placed on U.S. financial assistance during the Compact's first financial assistance period, the Amended Compact changed the method of management and disbursement of funding from direct payments to an annual grants program, with allocations going to six earmarked government sectors instead of general operations. The Fiscal Procedures Agreement (FPA) negotiated and agreed to by the FSM and U.S. as a subsidiary agreement to the Amended Compact, governs the grant process and sets forth detailed accountability procedures. The FPA uses the U.S. Common Rule for managing grants to states and local governments as its foundation but includes modifications that meet the Amended Compact's objectives and the unique circumstances of the FSM.

**FSM BUDGET PREPARATION STATUS:**  
During the 2004-2008 reporting period, budgets proposed by the FSM used a computerized database preparation system (BPS) that linked dollars to a multiplicity of activities but did little to explain the underlying basis for the allocations or provide coherent links back to the sectors' strategic goals. The same performance objectives appeared for education and health each year.

### ***Annual Sector Budgets***

The FPA requires the FSM to submit an annual budget proposal for each sector that reflects a multi-year rolling strategic development plan as the basis for performance goals and indicators measuring achievement progress. U.S. grant officials evaluate the proposals each year to ensure consistency with Compact requirements, program goals and objectives, and fiscal requirements to achieve their stated purposes. Budget consultations between the FSM and the U.S. take place prior to formal decision making on grant allocations by JEMCO.

### ***Grant Management Responsibilities***

The FSM: The responsibility for managing and monitoring the day-to-day programmatic and financial implementation of the sector programs resides with the FSM to ensure compliance with grant terms and conditions. Quarterly reporting from the FSM to the U.S., as required by the FPA, includes financial status data and written statements of performance. The FPA specifies that performance reports should include: (1) actual sector accomplishments compared against objectives established for the period; (2) any positive events that accelerate performance outcomes; (3) a description of any problem or issue encountered and its impact on grant activities; and (4) other relevant performance information including an analysis and explanation of cost overruns when appropriate.

**FSM COMPACT MANAGEMENT STATUS:** In 2005, the FSM formally established the Office of Compact Management (OCM) to oversee the coordination of the Amended Compact within the FSM. The office, administratively placed under the auspices of the FSM President, intended to provide a single point of contact for within-country Compact administration, managerial intercession and accountability monitoring, and for communicating with the U.S. OCM was understaffed, poorly equipped to carry out its duties, reluctant to provide the states with strong fiscal and performance directives, and failed to provide the states with general policy guidance on Compact implementation.

During 2004-2008, official quarterly fiscal and performance reports from the FSM often were incomplete or sent in late, if at all. The reporting formats and substantive content were of variable quality and usefulness, prompting OCM to commission the development of a new computerized performance reporting system (PRS) launched in 2008.

The Amended Compact requires the FSM to submit an annual report to the U.S. President on the use of Amended Compact grants and other Federal assistance provided during the preceding year and on progress in meeting the country's program and economic goals. However, the FSM has not consistently met the deadline, claiming that it did not have adequate personnel or resources to gather sufficient financial data for the reports.

**THE U.S.:** The United States has responsibility for monitoring FSM's sector performance, budgets and fiscal performance, and for ensuring compliance with grant terms and conditions. The U.S. Department of the Interior's Office of Insular Affairs (OIA) handles all grant management activities. The Amended Compact calls for the U.S. to assume a greater management role than called for in the original Compact.

In October 2003, OIA established a Honolulu field office to oversee the Amended Compact. Its Honolulu-based field office has four professional staff members that are specialists in health, education, infrastructure and financial administration and regularly travel to the FSM for purposes of performance and compliance monitoring. They also manage Amended Compact grants awarded to the Republic of the Marshall Islands. While in country, these individuals provide technical assistance and consult on budget planning and performance analysis, and help resolve specific issues of concern, among their other duties.

From 2004-2008, OIA employed a field representative stationed at the U.S. Embassy in Kolonia who kept track of Federal grants awarded to the FSM, assisted with grant monitoring and acted as a liaison for OIA. In addition, OIA's Honolulu office employs grant specialists to frequent

**FSM REPORTING STATUS:** During 2004-2008, official quarterly fiscal and performance reports from the FSM often were incomplete or sent in late if at all. The reporting formats and substantive content were of variable quality and usefulness, prompting OCM to commission the development of a new computerized performance reporting system (PRS) that launched in 2007. Additionally, the FSM has consistently not met the annual report deadline during this period.

FSM to oversee grants concerning their respective areas of expertise, including education, health and infrastructure.

### ***Enforcement Tools***

The FPA provides several enforcement tools to ensure the FSM's compliance with grant terms and conditions. These include: (1) the application of special conditions such as, but not limited to, requiring technical and management assistance, additional reporting, more monitoring and prior approvals; (2) the withholding of payments; (3) suspension or termination of grants; (4) annual audits; (5) specific audits; (6) full access to relevant records; and (7) cooperation with U.S. investigations.

### ***The Joint Economic Management Committee (JEMCO)***

Created by the Amended Compact, JEMCO's purpose is to strengthen management and accountability, and promote the effective use of Compact funding. The five-member committee has three U.S. representatives and two from the FSM. Designated responsibilities include:

- Reviewing the budget and development plans of the FSM, and monitoring progress in achieving sustainable economic development and budgetary self-reliance related to the country's written goals and performance measures;
- Monitoring the use of development assistance from all sources as it relates to the allocation of financial assistance under the Amended Compact;
- Approving grant allocations and performance objectives;
- Attaching terms and conditions to any or all annual grant awards to improve performance and fiscal accountability;
- Evaluating progress, management problems, and any shifts in priorities in each sector; and
- Reviewing audits required by the Amended Compact and actions taken by the FSM to reconcile problems and qualified findings.

The U.S. and FSM each provide staffing to enable members to closely monitor and evaluate the use of Compact assistance.

**ENFORCEMENT STATUS:** During the five-year reporting period, FSM's grant awards contained special conditions to improve program performance and to assist in the achievement of sector goals. Withholding sector payments, either in whole or in part, was occasionally necessary during the five-year reporting period to correct fiscal accountability or performance infractions. Release of funding followed the issue resolution. A suspension of grant funds for Chuuk occurred in FY 2007 because of a serious breakdown in fiscal accountability. The grants affected were environment, private sector development and public sector capacity building. JEMCO lifted the suspension once an experienced finance director came aboard.

JEMCO met near the end of FY 2003 to make its first grant allocations under the amended financial package. It has met annually since then to receive updated economic information from the FSM, consider grant allocations, and discuss the policy implications of funding and performance directions. Members also have convened special sessions in between regular JEMCO meetings for decision-making and technical consultation. Officials from the Departments of the Interior, State and Health and Human Services comprise the U.S. delegation. The Secretaries of Finance and Foreign Affairs represented the FSM from 2004 through 2006. In 2007, the Director of the Office of Compact Management and the FSM national government's Tax Reform Manager became FSM's representatives to JEMCO.

### From Generalization to Overall Strategic Development Plans and Annual Implementation Planning

The Amended Compact requires that the FSM have a multi-year rolling development plan that is strategic in nature, and continuously reviewed and updated through its annual budget process. The development plan includes: (1) specific multi-year objectives for FSM's grant sectors; (2) projections on the fiscal resources and commitments needed to achieve the objectives; and (3) projected levels of Compact assistance necessary to promote broad development goals and budgetary self-reliance. Concurrence of both the U.S. and the FSM is necessary to the extent that the framework contemplates the use of U.S. grant funds.

The Amended Compact also requires that the FSM submit a nationwide infrastructure development plan (IDP) to the U.S, and submit annual implementation plans to JEMCO. The GFSM in March 2005, presented the IDP, which covered sectors beyond the scope of compact's priorities. As a result, JEMCO resolved that it would concur with the sectors consistent with the FPA. Moreover, the annual plans were to include an integrated list of state and national infrastructure priorities proposed for sector funding and implementation schedules.

**PLANNING STATUS:** The FSM's Strategic Development Plan (Development Plan) uses a 20-year timeframe, from FY 2004 through FY 2023. It does not distinguish periodic targets or contain projections of the resources, Amended Compact or otherwise, needed to achieve the nation's strategic goals.

During the 2004-2008 reporting period, the FSM did not evaluate the progress made by the grant sectors nor did it revisit the Development Plan or IDP to see if nationwide goals and objectives remained relevant and achievable. Sector budget proposals became de facto annual implementation plans that lacked internal consistency and did not include narratives to provide specificity in terms of performance objectives that link back to the two national plans.

**PERFORMANCE MANAGEMENT STATUS:** The FSM found budgeting by performance objectives an important but onerous process to implement and needed more time to develop it fully. The FSM began developing its budgeting preparation approach (BPS) in 2003 as a stop-gap measure, and instituted the system in 2004. Budgets tracked organizational line item spending and numerical targets for sub-activities that did not correlate with national strategic outcomes, sector goals and quantifiable overall performance targets. Despite attempts to improve the clarity of the submissions by OIA and OCM, the deficiencies remained during the reporting period.

Because the budgets did not show relationships to performance indicators for the fiscal year, OCM attempted to improve tracking the FSM's approach through its quarterly performance reporting. The office hired consultants to develop software that would retool performance reports and to work with the states in developing specific sector performance measures. The effort, while well-intentioned, caused dissatisfaction and confusion among the states, produced reports with inaccurate expenditure summaries of activity-based outputs and blank descriptive pages, and obfuscated performance accountability. Evidence of the use of budgets to manage and monitor performance was minimal. (At the time of this report, OCM was no longer using consultants and was tackling how best to improve the system of performance reporting.)

### From Line Item Budgeting to Performance Management and Budgeting

In order to provide the reports required under the FPA, particularly those pertaining to budget development, execution and progress in achieving annual outcomes, the Amended Compact requires the FSM to provide budgets that include updated performance indicators for its sector grants. While the FPA does not mandate the use of performance-based budgeting as a specific approach to tie expenditures to performance goals, it does require that cost accounting structures report on operational costs at three levels: (1) on an entity-wide or agency basis, (2) by responsible segment, and (3) by segment outputs.

### From U.S. Discretionary Grants for Education to Supplemental Education Grant

In addition to Compact sector grants, the FSM began receiving approximately \$11.9 million (or as otherwise appropriated by the U.S. Congress) in annual funding through a Supplemental Education Grant (SEG) in 2005. The Amended Compact's implementing legislation authorizes appropriations for SEG to the Secretary of Education that replace or "cash-out" several U.S. education, health, and labor programs. Examples of the discontinued programs include, but are not limited to, Head Start (Departments of Education and Health and Human Services) and the Workforce Investment Act (Department of Labor).

Under the Fiscal Procedures Agreement, SEG funds are to be used to support "direct educational services at the local school level focused on school readiness, early childhood education, primary and secondary education, vocational training, adult and family literacy, and the smooth transition of students from high school to postsecondary educational pursuits or rewarding career endeavors."

SEG funds are appropriated to the Department of Education and transferred to the Department of the Interior for disbursement. Interior was responsible for ensuring that the use, administration, and monitoring of SEG funds are in accordance with a memorandum of agreement executed among the Departments of Education, Health and Human Services, Labor and Interior, as well as complying with the FPA. The Amended Compact requires that U.S. appointees to JEMCO "consult with the Secretary of Education regarding the objectives, use, and monitoring of United States financial, program, and technical assistance made available for educational purposes." A representative from the U.S. Department of Education attends annual JEMCO meetings to provide technical advice and ensure the effective use of SEG and the FSM's basic sector grant.

### From Reliance on Annual U.S. Assistance to Trust Fund Proceeds

The U.S. Trust Fund Agreement with the FSM states that the purpose of the Trust Fund is to contribute to the FSM's economic advancement and long-term budgetary self-reliance by providing an annual source of revenue after FY 2023 (the final year of annual Compact sector grants). Although the agreement maintains that the annual disbursements may not exceed the amounts that the FSM receives as grant assistance in 2023, it does not establish or guarantee a minimum disbursement level.

Under the Amended Compact, annual U.S. contributions to the Trust Fund increase by the same amounts as annual grants to the FSM decrease. In addition, PL 108-188 includes a partial inflation adjustment of the yearly contribution. The grant decrease and Trust Fund increment for the FSM is \$800,000 per year. The decrease for the FSM began in 2005.



## SOCIOECONOMIC PROFILE OF THE FEDERATED STATES OF MICRONESIA

### Population

The FSM's population grew rapidly at 3 percent per annum between the 1986 census and 1989. Table 1 on the following page shows the population numbers and growth rate by states from 1980 through 1994. Between 1989 and the next census count conducted in 1994, the rate fell to 1.9 percent, primarily results of lower fertility rates and modest rates of emigration. The rate fell even lower to 0.2 percent between 1994 and the most recent census in 2000. Falling fertility rates were a factor but most of the decline reflected outward migration to Guam, the Commonwealth of the Northern Mariana Islands, Hawaii and the U.S mainland under the migration provisions of the Compact.

The FSM's negative growth rates occurred after the second step-down in financial assistance under the original Compact and correlate with the economic downturn experienced throughout the nation. Large-scale migration followed the fiscal contraction for better employment opportunities and better rates of remuneration in the U.S.

In the long term, FSM migration will play an equilibrating role: as incomes decline, outward migration will compensate to improve the average income levels for individuals remaining in the country. However, outward migration will have a distorting impact if it causes a large loss of economically active and skilled workers. This loss of human capital will reduce the long-run productive potential of the economy.

Table 1: Population by state and annual average growth rates

	Population numbers				Annual average growth		
	1980	1989	1994	2000	1980-89	1989-94	1994-00
Chuuk	37,488	47,871	53,319	53,595	2.7%	2.2%	0.1%
Kosrae	5,491	6,835	7,317	7,686	2.4%	1.4%	0.8%
Pohnpei	22,080	30,669	33,692	34,486	3.7%	1.9%	0.4%
Yap	8,100	10,365	11,178	11,241	2.7%	1.5%	0.1%
<b>FSM</b>	<b>73,159</b>	<b>95,740</b>	<b>105,506</b>	<b>107,008</b>	<b>3.0%</b>	<b>1.9%</b>	<b>0.2%</b>

Source National Census Report May 2002

# Migration

## Out-migration

The out-migration of FSM citizens, as measured by net movements of departing air passengers from 2004 through 2008, has been large. Figure 1 below illustrates the strong relationship between real incomes and migration. In all states, real incomes either fell or remained largely stagnant, reflecting poor economic performance during the last 13 years.

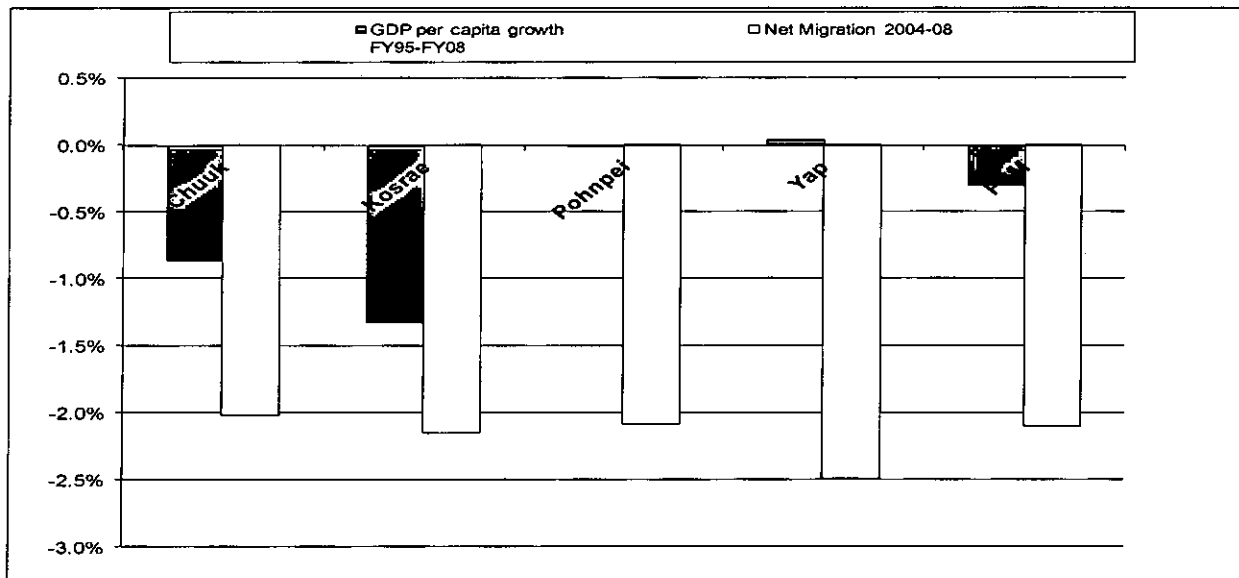


Figure 1: Losses and growth in per capita GDP and emigration (annual averages)

## Compact Impact

PL 108-188 authorizes and appropriates a fixed annual amount of \$30,000,000 for grants to affected jurisdictions (Hawaii, American Samoa, Guam and the Commonwealth of the Northern Mariana Islands). The funding is to help defray costs incurred as a result of increased demands placed on health, education, social, public safety or infrastructure issues related to the migration of qualified non-immigrants from the freely associated states (FAS), which include the Republic of the Marshall Islands, the Federated States of Micronesia and the Republic of Palau.<sup>2</sup>

An enumeration of FAS migrants residing in the four jurisdictions determines the division of the Compact Impact Fund. Based on the count of FAS migrants conducted in 2003 and 2008 under

<sup>2</sup> In addition to the \$30 million a year already appropriated, appropriations for fiscal year 2012 included \$5 million in discretionary funds for impact of compact purposes.

the supervision of United States Bureau of Census, the distribution among the affected jurisdictions was as follows:

<u>Jurisdiction</u>	2003	2008
	<u>Migrant Count</u>	<u>Migrant Count</u>
Hawaii	7,297	12,215
Guam	9,931	18,305
CNMI	3,570	2,100
American Samoa	10	15
<b>Total</b>	<b>20,808</b>	<b>32,635</b>

The Census Bureau did not enumerate FAS migrants in the 48 contiguous states or differentiate among Palauans, Micronesians, and Marshallese. The 2010 U.S. census will generate the most accurate count of all Micronesians across the country. From anecdotal information, significant clusters of FSM citizens reside across continental U.S., including in Washington State, Oregon, California, Missouri and Texas.

The consensus is that the majority of FAS migrants come from the FSM. Under the Amended Compact, the next five-year count of migrants is due in 2013. The count will exclude the continental United States.

## **GDP, Growth and Structural Change**

### ***Steady Decline in Economic Activity***

FSM's overall economic performance was poor during the five-year reporting period, reflecting Amended Compact adjustment problems experienced by the country, lack of a positive environment to support private sector growth, as well as declines in fish licensing revenue. The FSM economy contracted in all but one year from FY 2003 through FY 2008, and GDP fell by 4.1 percent overall, or an annual average of 0.8 percent. The public sector showed a continuing decline. Both FY 2007 and FY 2008 showed very significant economic declines from actions to reduce public expenditures in Kosrae and Chuuk. Most of the cost-savings came from a reduction in public sector payrolls. Private sector activity was also weak from FY 2003 through FY 2008, showing an annual rate of decline of 1.2 percent. This downturn reflects the reduced demand for private sector business from the public sector.

Significant contributors to the FSM's economic decline from FY 2004 through FY 2008 included: (1) the lack of economic development, and (2) the lack of tax reform that would encourage

foreign investment. Other governmental problem areas that need attention and (1) the annual reduction in direct grant funding under the Amended Compact that began in FY 2007; (2) the reduction in the public sector workforce of Chuuk and Kosrae in 2008; (3) a lack of capacity to meet new fiscal procedure requirements; and (4) the need to gradually use general revenue to cover non-conforming uses of the Public Sector Capacity Building grant beginning in FY 2005. Real per-capita incomes fell \$98 from \$2,213 to \$2,115.

A reduction in the public sector employment roll by 1,039 jobs, or 6 percent, contributed to FSM's weak economy. As incomes fell, the economy failed to provide alternative work-producing opportunities to the population, due to lack of attention to private sector development. Outward migration continued at 2.1 percent per annum.

The implementation of recent measures to begin adjusting to decreasing annual Compact assistance reduced the country's fiscal deficit 1 percent of GDP.

Table 2 below describes FSM's economic performance from FY 1995 through FY2008. The data indicate that public sector accounted for most economic growth and competed with the private sector. The overall result is disappointing: GDP growth declined and the private sector contracted.

From FY 1995 through FY 2008, the country's economy declined by 0.1 percent. This downturn reflected economic performance in each of the FSM's four states. Growth in Chuuk and Kosrae recorded annual declines of -0.9 percent and -0.5 percent. Pohnpei and Yap achieved positive but small rates of economic growth of 0.2 percent and 0.4 percent, respectively. Growth in the public sector reflected the economy at large, with both Chuuk and Kosrae recording negative growth. Pohnpei and Yap achieved positive results. In all states, the private sector contracted during the period.

Table 2: FSM Economic Performance from FY 1995 through FY 2008

	FY1995-FY2008			2nd Step-Down FY1995-FY1997			Final Phase Compact I FY1997-FY2003			Compact II FY2003-FY2008		
	GDP	Gov	Private	GDP	Gov	Private	GDP	Gov	Private	GDP	Gov	Private
Chuuk	-0.9	-1.6	-2.0	-4.4	-5.1	-11.8	2.6	3.2	4.3	-3.5	-5.7	-6.1
Kosrae	-0.5	-0.7	-0.5	-3.0	0.3	-8.4	0.8	-0.4	2.5	-1.1	-1.5	-0.8
Pohnpei <sup>2</sup>	0.2	0.5	-0.3	-7.1	-3.8	-7.8	1.8	1.7	-0.1	1.4	0.9	2.6
Yap	0.4	0.3	-0.5	0.8	-0.7	3.2	1.8	-0.6	1.9	-1.3	1.9	-4.8
<b>FSM</b>	<b>-0.1</b>	<b>-0.7</b>	<b>-0.2</b>	<b>-4.6</b>	<b>-6.9</b>	<b>-3.4</b>	<b>2.0</b>	<b>1.6</b>	<b>1.7</b>	<b>-0.8</b>	<b>-0.9</b>	<b>-1.2</b>

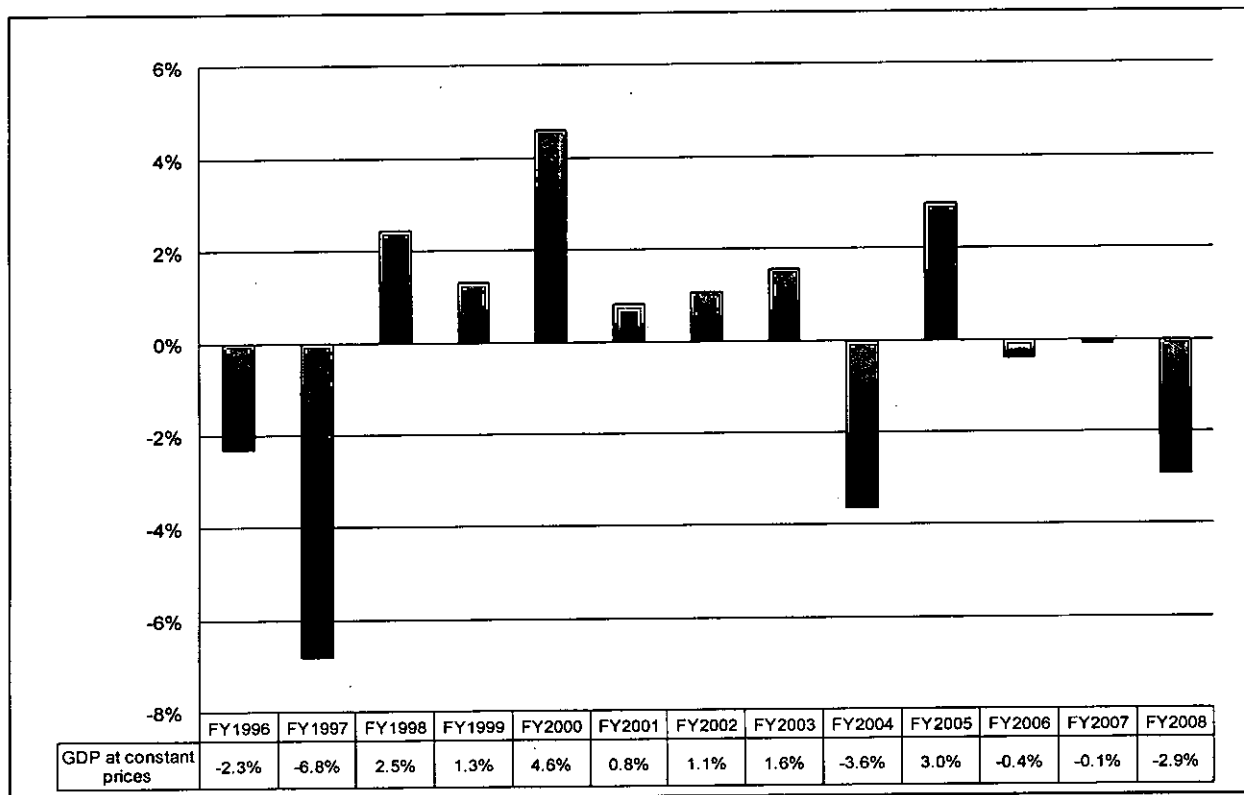
Notes 1 Growth rates annual averages based on period end points.

2 Pohnpei includes the FSM national government.

Figure 2 below shows economic development from FY 2004 through FY 2008. The FSM experienced growth in FY 2002 and FY 2003 because of the infusion of two years of bumped-up U.S. funding under the original Compact. The economy went into recession in FY 2004 as the

level of Compact funding fell to a level lower than FY 2003. Compact receipts from fell from \$84 million (Compact I level without bump up) to \$76 million.

Figure 2. Changes in FSM GDP 1996-2008



### Employment and Wages

Employment figures were very disappointing from FY 2004 through FY 2008. The lack of job creation activity reinforced an already strong incentive to migrate to the U.S. for employment opportunities and higher wages. Table 3 on the next page shows that from FY 1995 through FY 2008, sector employment contracted by an annual average rate of -0.9 percent (-11% over the period) and was unable to provide enough jobs for new job seekers. Over the period, approximately 1,930 jobs were lost in Chuuk, 123 in Kosrae, and 104 in Yap. Pohnpei managed to generate an additional 246 new jobs that represented some 3 percent of the state labor force.

Public sector employment contracted overall in all states except Pohnpei. The situation followed the downsizing of the public sector after the second mandatory step-down in original Compact funding and the completion of an FSM-wide reduction in force in FY 2007 that

intended to mitigate the country's growing economic troubles. Private sector employment generation was positive in Kosrae and Pohnpei but contracted in Chuuk and Yap.

Table 3: Employment Growth Rates by Sector and State (annual averages)

	FY1995-FY2008			2nd Step-Down FY1995-FY1999			Final Phase Compact I FY1999-FY2003			Compact II FY2003-FY2008		
	Total	Gov	Private	Total	Gov	Private	Total	Gov	Private	Total	Gov	Private
Chuuk	-2.9%	-4.2%	-1.3%	-4.4%	-5.9%	-3.8%	0.8%	0.5%	2.2%	-5.7%	-7.9%	-2.5%
Kosrae	-0.7%	-2.2%	2.3%	-0.2%	-3.9%	5.0%	1.7%	0.9%	5.4%	-3.6%	-4.1%	-2.6%
Pohnpei	0.3%	0.7%	0.8%	-1.5%	-0.3%	-1.8%	-0.1%	1.7%	-1.1%	2.4%	0.8%	5.8%
Yap	-0.3%	-0.5%	-0.2%	1.5%	-4.0%	5.7%	1.3%	0.1%	2.6%	-3.7%	2.5%	-8.5%
FSM	-0.9%	-1.6%	0.2%	-1.9%	-3.5%	-0.4%	0.6%	0.9%	1.2%	-1.6%	-2.6%	-0.1%

Source: FSM Social Security Administration Data

Fig. 3 shows trends in private and public sector employment since FY 1995. Employment in the public sector contracted severely after the second step-down in original Compact funding, reflecting a major fiscal adjustment. By FY 2000, employment in the public sector fell from 8,826 in FY1995 to 7,132, for a 19 percent reduction. From FY 2000 through FY 2008; however, public sector employment showed an oscillating trend that primarily reflected the fiscal condition of Chuuk state.

Private sector employment contracted between FY 1995 and FY 1997 that paralleled contraction in the public sector, but rose strongly between FY 1997 and FY 2000 as the economy improved after FSM adjusted to the second mandatory step-down in original Compact funding and after resolution of the earlier fiscal crisis in Chuuk. From FY 2000 through FY 2008, private sector employment fell by a significant 6 percent.

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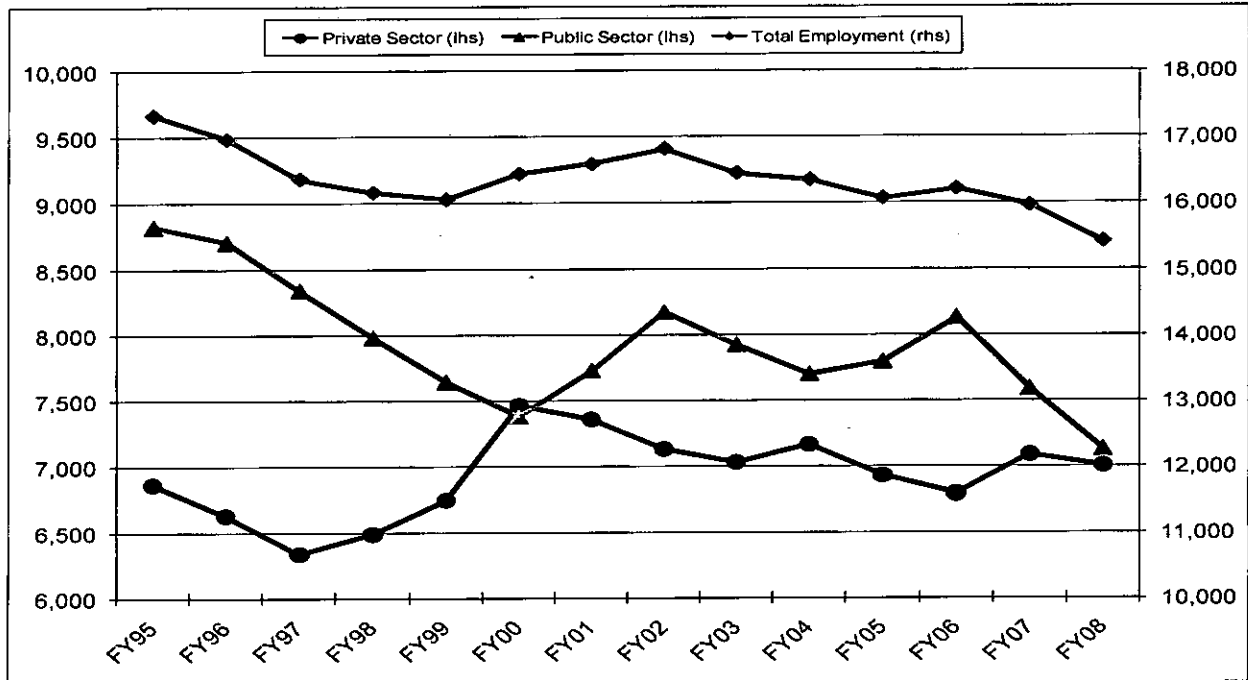


Figure 3: Employment by sector, FY1995–FY 2008

### Wage Rates

Amended Compact-fueled high public sector wage rates distort the FSM labor market. Other contributing factors include the ease of migration; the availability of higher wages in Guam and other U.S. labor markets; and the opportunity cost of labor in the subsistence sector. Table 4 below shows the level of real wages by state and compares the private and government sectors. From FY 2006–FY 2008, government wages for the FSM as a whole were 120 percent higher than the private sector. While the skill mix of the two activities affects the differential, public sector policies clearly assert an upward pressure on wages and influences the allocation of labor between the sectors.

Table 4: FSM Real Wages from FY 1995 through FY 2008

	Real Public Sector Wages (2004 US\$)		Real Private Sector Wages (2004 US\$)		Differentials	
	Average FY95-FY97	Average FY06-FY08	Average FY95-FY97	Average FY06-FY08	Average FY95-FY97	Average FY06-FY08
Chuuk	6,303	6,100	3,238	2,862	195%	213%
Kosrae	8,031	7,274	3,217	2,865	250%	254%
Pohnpei*	12,061	9,935	4,661	3,967	259%	250%
Yap	7,665	6,703	3,799	3,898	202%	172%
<b>FSM</b>	<b>8,581</b>	<b>7,870</b>	<b>4,006</b>	<b>3,580</b>	<b>214%</b>	<b>220%</b>

Policy has its limitation in influencing distortions in the labor market. For example, the effect of unrestricted emigration is a basic right of FSM citizens under Title I of the Amended Compact. However, during the Second FSM Economic Summit, the country adopted a policy to reduce the differential between the private and public sectors. The data shown in Table 4 indicate that Yap achieved this policy objective but there was a significant increase in the disparity in Chuuk. In Pohnpei and Kosrae, the differential changed little. Real wages fell significantly in the FSM by 8 percent in the public sector and 11 percent in the private sector from FY 1995 through FY 2008.

### **External Debt**

Heavy borrowing by FSM governments raised the nation's total official external debt to a level of \$120 million at the end of FY 1995, representing 55 percent of FY 1995's GDP. Before FY 1990, the FSM had no official public sector debts to offshore lenders. From FY 1990 through FY 1993, however, the nation rapidly increased its external public borrowing. New public sector debts during that period included: (1) MTN bonds (medium term notes) issued for \$71 million to finance portfolio investments by Yap State, and (2) \$42.9 million for fisheries-related investments in Pohnpei, Chuuk and Kosrae and for the National Fisheries Corporation. Public-guaranteed borrowing also included \$41 million from the U.S. Rural Electrification Administration to the FSM Telecommunications Corporation and \$9 million to the Yap Fishing Corporation.

The FSM adopted a prudent external debt management strategy since the issue of the MTNs in the early 1990s and external borrowing has been modest. The FSM continued to draw on ADB loans in FY 1999 and FY 2000 but the order of magnitude was small. There were no further commitments until the ADB's Private Sector Development Program (PSDP) in FY 2003 and the Basic Social Services Program loans became effective in FY 2004. Draw downs under both programs were not extensive since several of the FSM states did not qualify for the loans or meet the conditions for second tranche drawdown. The only remaining external loan is the ADB Omnibus Infrastructure loan to finance specific projects in the FSM states.

From FY 2004 through FY 2008, the FSM external debt level was manageable. This favorable outcome was the result of completing the MTN program. Final repayments came from Compact revenues in FY 2001. With a debt-to-GDP ratio of just 27 percent in FY 2008, the country's debt level is low by Pacific Island standards. Furthermore, with the remaining debt on concessional terms, the projected debt service ratio in FY 2008 was at the low level of 6 percent of exports of goods and services.



## Fiscal Policy

Fiscal policy exists for the national and state governments; however, separate expenditure and revenue policies lack coordination. With respect to revenue policy, the FSM national government has the constitutional power to collect import and income taxes. All remaining taxes are under the states' authority but they have widely varying levels of effort. Through its taxing powers, the national government collects about three-fourths of all domestic taxes. In FY 2008, national taxes amounted to \$22.2 million while the four states collected an additional \$7.1 million from general sales taxes and excise taxes on alcohol, tobacco and other goods.

By constitutional mandate, the FSM national government must share at least 50 percent of the nationally imposed taxes (and 80 percent of the fuel import tax) with the state that collected the taxes. While the overall tax effort remained low relative to other Pacific islands, there was a gradual increase over time. In FY 2008, tax revenues were 11.6 percent of GDP, compared to the 10.8 percent average rate that prevailed from FY 1987 through FY 2003 (the period under the original Compact). The small increase was due largely to tax increases on beer and tobacco (effective FY 2005) and a policy change that shifted the point where the import tax is levied from f.o.b. (free on board) to c.i.f. (cost, insurance and freight). However, deductions allowed against the GRT (gross receipts tax) for payroll costs offset the increased revenue.

Fishing access fees dominated non-tax revenues. These fees represented nearly one-quarter of all domestic revenues during the five-year reporting period. The FSM national government managed tuna resources and kept all revenues from licensing fees. Specific states and some local governments shared revenue from penalties and fines. The fishing access fee as a source of revenue grew rapidly from less than \$4 million in FY 1987 to a peak of over \$21 million in FY 1995. It subsequently dropped back and averaged \$14.1 million from FY 2004 through FY 2008. The declining trend for this revenue source was the leading cause of the country's deteriorating financial position.

From 1986 through FY 2003 (original Compact), the FSM national government acted as the agent for distributing U.S. Compact funding to each state government according to a mutually agreed formula that split 30 percent evenly among the four states and the remaining balance according to population. The FSM national government received just fewer than 15 percent of grants and 10 percent of capital funds. The remainder went to the states. The formula was in effect before the original Compact went into effect and remained the same until the Amended Compact came into force.

With the advent of the Amended Compact, there was a consensus that the formula needed revision to provide a larger share to the states where fiscal pressure was greatest. At a meeting of the Economic Policy Implementation Council (EPIC) in October 2003, the formula was changed to reduce the FSM national government's share to 8.65 percent. The distribution of the remaining Compact revenue would be similar to the prior formula. However, with mounting fiscal pressure on the FSM national government in FY 2005, the FSM Congress

enacted legislation to increase the FSM national government's share to no less than 10 percent. The new distribution law took effect in FY 2007.

On the expenditure side of fiscal policy, the five governments operated within "balanced budget" requirements based on either constitutional or statutory provisions from FY 2004 through FY 2008. However, the definition of a balanced budget was not restricted to the operations of a single budget year. Funds unexpended in one year became revenues in the following year. The use of this so-called "carry-over" component in projecting revenue tended to cloud financial management and masked the onset of significant structural imbalances. Delays in financial reporting and weak expenditure controls compounded the FSM's vulnerability to fiscal imbalance. The result was that all legislative bodies must make appropriations without an accurate appraisal of each government's true financial position.

Reviewing the structure of the country's five fiscal accounts on a consolidated basis reveals an extensive dependence on external grants despite a downward trend in external revenue. As shown in Table 5, grants represented 51 percent of GDP in FY 1995 and 42 percent in FY 2001 (near the end of the original Compact). U.S. grants represented an estimated 37 percent of GDP in FY 2008. However, the figures in future years may turn higher as the FSM overcomes capacity bottlenecks and draws down on public infrastructure grant assistance.

Table 5: Comparative analysis of fiscal structure FY1995, FY2001, and FY 2007

<b>FY95</b>	Chuuk	Kosrae	Pohnpei	Yap	National	FSM
Grants as % of GDP	49%	81%	29%	48%	9%	51%
Grants as % of Total Revenue	84%	84%	79%	68%	38%	66%
Tax Revenue as % of GDP	5%	6%	6%	7%	4%	10%
Total Expenditure as % of GDP	58%	87%	43%	71%	24%	78%
Overall Balance as % of GDP	1%	10%	-6%	0%	1%	0%
<b>FY01</b>						
Grants as % of GDP	40%	73%	25%	42%	8%	42%
Grants as % of Total Revenue	79%	90%	70%	74%	48%	68%
Tax Revenue as % of GDP	8%	11%	10%	9%	3%	12%
Total Expenditure as % of GDP	60%	87%	33%	47%	22%	68%
Overall Balance as % of GDP	-9%	-5%	3%	9%	-6%	-6%
<b>FY08</b>						
Grants as % of GDP	30%	45%	17%	40%	10%	37%
Grants as % of Total Revenue	81%	74%	68%	81%	44%	63%
Tax Revenue as % of GDP	6%	13%	7%	8%	4%	12%
Total Expenditure as % of GDP	36%	64%	29%	55%	23%	61%
Overall Balance as % of GDP	1%	-3%	-3%	-5%	1%	-2%

The Amended Compact avoids the need for large fiscal adjustments every five years, as was the case under the terms of the original Compact. However, in order to promote the viability of the Amended Compact's Trust Fund, the U.S. and the FSM agreed to an annual \$800,000 decrease in sector grant assistance. Although the decrease avoids large shocks to the FSM's economic system, it requires an annual compression of expenditures from FY 2007 onward. This compression, coupled with the lack of full inflation adjustment, means an annual reduction in real resources of about 2 percent per annum. The FSM therefore needs to make significant

fiscal policy adjustments unless it develops a set of policies that is sufficient to attract new private sector investment, which, in turn, may generate enough economic growth to offset the revenue decline.

### **Developments in the Private Sector**

The FSM faces considerable challenges in realizing its economic potential. The country's economy scores poorly on many of the 10 components<sup>3</sup> of economic freedom, and growth has been erratic. From FY 2004 through FY 2008, economic activity concentrated in the public sector, the largest source of employment.

The FSM's tariff barriers are relatively low but these still limit overall trade freedom, as does the country's poor trade infrastructure. During the five-year reporting period, development of the private sector was marginal because of a business environment that was often hostile to entrepreneurial activity. Low scores in business freedom, investment freedom, and financial freedom and property rights indicate that the overall regulatory and legal framework remains inefficient and lacking in transparency.

The formation or operation of private enterprises in the FSM was not easy from FY 2004 through FY 2008. Inconsistent application of commercial regulations and the regulatory framework's lack of transparency discouraged entrepreneurial dynamism. The FSM's simple average tariff rate was 4.5 percent in 2007. Some high tariffs, import restrictions, inadequate infrastructure and underdeveloped markets added to the cost of trade.

Foreign investment is treated inconsistently in the FSM. All foreign investment was prescreened by the FSM government. The states licensed and regulated all other sectors and some state governments imposed additional restrictions. Regulations were non-transparent and applied inconsistently. The enforcement of contracts was weak. Foreign investors cannot own land but only lease it for short periods. Each of the FSM's four states' unique foreign investment laws and regulations potentially can counter FSM national policy.

The FSM's financial sector is small and not well developed. It cannot generate and support sustainable dynamic entrepreneurial activity. Outmoded regulations, high credit costs and

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<sup>3</sup> The ten components of economic freedom, as defined in 2011 by the Heritage Foundation are:

- Business Freedom
- Trade Freedom
- Fiscal Freedom
- Government Spending
- Monetary Freedom
- Investment Freedom
- Financial Freedom
- Property Rights
- Freedom from Corruption
- Labor Freedom

scarce access to financing constrain the small private sector. During the five-year reporting period, much of the population remained outside of the formal banking sector. Banking dominated the financial sector, including one state-owned development bank and two commercial banks. One of the commercial banks is majority government-owned. State influence in allocating credit was substantial, and government-controlled or government-owned banks made a majority of all loans.

As noted above, the FSM does not permit foreign ownership of land. The states control lease terms for real property and leases are usually limited to relatively short periods. Squatters, long-standing and multiple disputes over land ownership and the absence of property records make leasing land extremely difficult, costly and even uncertain in some locales. Transfer of title sometimes occurs informally, and this causes a lack of accurate public pricing information. The situation did not change during the five-year reporting period.

## **ECONOMIC RISKS AND VULNERABILITIES**

### **Macroeconomic Weaknesses**

The promotion of FSM's economic advancement and budgetary self-reliance is the principal aim of U.S. assistance under the Amended Compact. Well-timed macroeconomic reforms undertaken by the FSM, in conjunction with the Compact's financial arrangements and subsidiary agreements, provides a workable framework for increasing the economic productivity of the nation. Successful progress in the years leading up to FY 2023, however, requires the committed attention of the FSM.

Over the five-year reporting period, actions taken by the FSM to improve its sluggish economic climate were ponderous and did not comply with the spirit or letter of the Amended Compact itself or the FPA governing accountability. The FSM treated the Compact grants as contractual entitlements intended for equitable allocation among the states and as substitute financing for general fund support to programs and services instead of as a stimulus for growth and institutional improvement. Even budget crises in two of the four FSM states in FY 2007 did not prompt a sense of urgency to undertake nationwide financial reforms.

U.S. sector grant funding from FY 2004 through FY 2008 became a safety net for budgetary shortfalls in the states. The greater levels of financial assistance provided by the Amended Compact, in contrast to the original Compact, created a misconception that the FSM could maintain the status quo even in the face of mandatory annual decreases.

The maintenance of government payrolls came at the expense of the development of effective programs and the undertaking of essential, even though painful reforms. Government officials

at all levels seemed unable to improve basic social services as called for by the Amended Compact without continuing the pattern of unsustainable growth in the public sector. The FSM chose to defer planning for grant decreases and other necessary long-term steps to ensure fiscal stability. The result was lost time, lost opportunities, a declining economy and a continued over-reliance on public sector employment.

The lesson of the first five years of the Amended Compact is that success of the Amended Compact will prove elusive unless the FSM improves its policy environment, reduces expenditures and increase revenues, and commits to an institutional framework for sustainable private sector growth that complies with the terms of the Amended Compact.

### ***Lack of Essential Reforms***

The FSM did not make progress in planning and implementing the essential reforms necessary for economic growth. The areas included:

- Reform of FSM national and state tax laws to encourage domestic and foreign private investment and increase government revenue and fiscal stability;
- Correct land title and land lease problems that hobble capital investment in both public sector infrastructure development with U.S. Amended Compact funding and private sector investment;
- Encourage the FSM national government and all four states (especially Chuuk and Pohnpei) to adopt consistent direct foreign investment laws that will help the private sector grow;
- Plan for an orderly reduction in public sector employment in response to the coming decreases in Compact funding and to make room for private sector development;
- Act on the 2001 Aries Report for reform of public utility functions, ownership and rates to ensure the reliability of power, potable water, communications and wastewater management;
- Identify public infrastructure needs, design and construction; and
- Institute regular economic planning and statistical analyses by the FSM national and state governments for setting priorities and making policy decisions.

### **Tax Reform**

The FSM's existing tax regime served reasonably well during the FSM's early days as a sovereign country but needs modernization and other reforms. As is, it lacks a strong foundation for expanding government revenue without distorting economic incentives. Both the short- and long-term impact of reduced Amended Compact funding highlights the urgent need to institute measures to increase revenues to prevent the burden of fiscal adjustments from falling entirely on cutting public sector expenditures.

### ***Slow Pace of Reform***

In 2002, the FSM convened a nationwide symposium to raise the awareness of tax and revenue problems and encourage reform. The symposium passed two important resolutions. First, it recommended the introduction of a comprehensive tax reform program, including the introduction of a broad based consumption tax (value-added tax plus excise taxes) and, once done, the establishment of a simple net profits tax. The symposium called for enactment of the consumption tax at the state level to replace existing national gross revenue tax and state sales taxes. The second recommendation was for the establishment of a unified tax administration to implement the new regime and collect taxes on behalf of both layers of government.

In 2004, the FSM national government convened the FSM's Third Economic Summit to develop the country's Strategic Development Plan (SDP). The Plan in part called for a modern nationwide tax system that increased revenue in an economically efficient way, shared the burden equitably, fostered private sector development, and improved the business climate. The Economic Summit presented varying scenarios of economic growth that ranged from "dismal" (the FSM would fail to generate economic growth and citizens would emigrate (mainly to U.S. jurisdictions) due to a lack of opportunities) to a preferable "sustained growth scenario" that would require additional domestic resource mobilization, to adjust to the conditions of the Amended Compact and support public infrastructure development. Despite progress on technical issues, the process remained stalled given the political cycle in which elections are held every two years, and because of continued issues of burden-sharing across state and national levels. Additionally, to sustain economic growth, the FSM needed a modern tax regime that encouraged private sector investment.

The initiative to reform the FSM's tax administration system and tax structure spurred a flurry of discussions and activity but did not result in enacted changes to the tax system during the five-year reporting period.

In January 2005, the FSM President formally created a Tax Reform Task Force (TRTF) whose role was to:

- Examine different options for reform of the FSM tax system to meet expected reductions in revenues and to support the long-term sustained economic development of the nation;
- Prepare a tax reform proposal to present to the leadership of the FSM executive and legislative branches of government for consideration and enactment at the earliest possible time; and
- Assist in education, seminars and working groups to increase public awareness of the fiscal implications of the Amended Compact and the need to generate more local revenue, to effect tax reform and to strengthen tax administration.

In June 2005, the TRTF submitted to the president its final recommendations, which the President approved in December. The key recommendations included:

- Establishment of a new modern independent tax collection authority with operations nationwide;
- Introduction of a new Net Profits Tax (NPT) that allows for deductions of business expenses (the NPT will replace the existing Gross Revenue Tax (GRT)); and
- Introduction of a new Value-Added Tax to replace import duties and state sales taxes

In September 2005, the reform proposal was put to the Economic Policy Implementation Council (EPIC) and adopted by resolution (the Council adopted similar resolutions on previous occasions). Congress similarly adopted the reform proposal (for the first time) in September 2005 and requested that the President establish an executive steering committee (ESC) that would have governance responsibility for implementing tax reform in the FSM.

Laws were drafted for the creation of a Unified Revenue Authority (URA), a new Revenue Administration Act, and new VAT and NPT laws. At the inaugural meeting of the ESC in June 2006, the ESC adopted the creation of a Technical Working Group (TWG) responsible for determining the core tax and administrative policy for the ESC to approve.

In April 2007, the ESC convened again and reaffirmed its commitment to the tax reform initiative. During the same meeting, the steering committee also endorsed a high-level implementation plan and asked the states to create state implementation teams (SITs) to help accelerate tax reforms at the state level. The Committee tasked the Technical Working Group with preparing a detailed implementation plan and a tax reform package to submit to each of the FSM states.

The FSM created the Tax Reform Unit in late 2007 to manage the reform process. Based on the high-level implementation plan endorsed by the ESC in April 2007, the unit developed a detailed operational plan for implementing tax reforms in December 2007 with the assistance of the Pacific Finance Technical Assistance Center (PFTAC). The plan included a timeline of activities from 2007-2010 and includes five sub-plans:

- Project Management and Governance Program;
- Law, Policy and Estimates Program;
- Tax Administration and Tax Change Program;
- Business & Community Program; and
- VAT registration Program.

### ***Implementation Projected in FY 2011***

The finalization and transmission of the legislation to FSM's five law-making bodies will be a key milestone in the tax reform process. While this last step was to occur in July 2008, it stalled because of several significant legal issues concerning the constitutionality of the legislation at the state level. The states signaled their acceptance of amendments to the draft law. There are several minor issues concerning state VAT laws that still need resolution. Once the draft bills receive ESC endorsement, they will be ready to transmit to the respective legislatures for consideration. If enacted, implementation will occur over a year and a half, in three six-month installments. The first phase will be the creation of the Unified Revenue Authority. The second phase will implement the net profits tax. The last phase will be the implementation of the VAT. The FSM projects that the new tax regime, some nine years in the making, should be operational by mid-2011.

### **Foreign Investment Reform**

#### ***Model Law Developed***

Until the late 1990s, the FSM national government regulated foreign investment in the country based on an outdated law enacted during the Trust Territory days. The states sought decentralization and assumed control after complaining about the slow processing of permits, insufficient sensitivity to local concerns and the usurpation of state powers by the FSM national government. A handful of sectors of undisputed nationwide interest remained with the FSM national government.

While the states sought decentralization, the restrictiveness and lack of transparency in the existing law concerned development experts and foreign investors. Their complaints prompted the adoption of a new foreign direct investment (FDI) regime by the FSM national government in 1997, and three of the states followed soon after. Pohnpei already had a foreign investment regime of its own and did not want to adopt the same approach as the other states.

The new foreign direct investment (FDI) had four goals:

1. Decentralization
2. Uniformity of structure
3. Less restrictive rules
4. Transparency



### ***Attempted Nationwide Implementation***

The new regime achieved decentralization but required investors to apply for more than one permit if they wished to operate in more than one state. Because Pohnpei maintained a Foreign Investment Board type of approach to FDI, the objective of implementing a uniform structure to FDI was unachievable. While there was some improvement in easing restrictiveness and increasing transparency, changes that each state government made to the model FDI subverted the model FDI legislation.

The FDI regime in the FSM is highly dependent upon regulations. In each government, the statute establishes only a framework, leaving the details to the regulatory process. Since regulations implement statutes, an amendment to the regulations is generally necessary after any significant amendment to the statute, thereby creating a time-consuming two-step process.

### ***Uneven Treatment by the States***

The progress made by each government to implement the new FDI regime varied. The FSM national government needed to amend its existing statutes and implement compliant regulations. The FSM Congress enacted the revised bills and regulations came into force by the end of 2005. In Kosrae, the State Legislature passed the proposed changes. The Governor signed the amended bill and regulations into law. In Yap, changes took effect by the end of 2005 bringing their laws in line with the FDI model.

Chuuk and Pohnpei are often hostile to foreign investment. Chuuk proposed revisions to the law and the regulations in 2005. Even though there was no opposition to the changes, there was no further movement for adoption of FDI. Legislation passed by Pohnpei in December 2006 prohibits FDI in many service sectors that compete with local interests. The law reserves tourist support services for local business but larger hotels (more than 12 rooms) are available for foreign investment.

### **Public Enterprise Reform**

The FSM has not given Public Sector Enterprise (PSE) transformation the attention it needs. Much of the groundwork for PSE reform came from an Asian Development Bank (ADB)-funded technical assistance grant entitled, *Privatization of Public Enterprises and Corporate Governance Reform*. The ADB released its final report (commonly called "The Aries Report") in 2001 that identified a variety of reform activities, including liquidation, divestiture, corporatization, commercialization, governance reform, and outsourcing of goods or services. Although the report proposed an institutional structure for reform and identified suitable candidates for transformation, the FSM had not taken action during the five-year reporting period to reform its public sector.

## Compact Trust Fund Viability

### ***Trust Fund Provisions***

The establishment of the Trust Fund for the People of the FSM is a major feature of the Amended Compact. The purpose of the Fund is to *contribute* to the economic advancement and long-term budgetary self-reliance of the FSM by providing an annual source of revenue, after fiscal year 2023, for assistance in the sectors described in section 211 of the Compact, as amended or other sectors as mutually agreed, with priorities for education and health care.

Neither the Amended Compact nor the Trust Fund Agreement contains a commitment, either express or implied, regarding the level of the revenue that the Trust Fund will generate. Also, the Trust fund Agreement contains no commitment on the degree to which the revenue will “contribute” to the long-term budgetary self-reliance of the FSM.

### ***Projected Level and Actual Value***

The corpus of the trust fund, at present, will not be able to support in 2024 the amount of FSM government projected to be funded in 2023. Thus, in 2024, additional projected funding decreases will force a further shrinking in FSM governmental structure.

Several factors affected trust fund performance:

- It was anticipated that the trust fund would be established on October 1, 2003. The Amended Compact, however, did not come into force on June 25, 2004. The trust fund was incorporated shortly thereafter on August 17, 2004.
- Although available on October 1, 2003, the FSM did not deposit its required \$30 million contribution until October 1, 2004, exactly one year later than originally anticipated. No U.S. deposit was to be made until after the FSM funds were deposited. The U.S. made its initial deposit of \$16 million on October 5, 2004.
- In the early period of the trust fund while investment policies were being established, funds were invested at were invested at maximum interest rates. The Trust Fund experienced a historically volatile and negative period early in the accumulation period. Due to U.S. and world-wide recession of 2008 and 2009, however, the trust fund corpus eroded substantially. (Note: since the stock market nadir in March 2009, the trust fund corpus has recovered much of the loss it sustained in the downturn.)
- While fund investment followed the asset allocation identified in the Trust Fund’s investment policy (2006) through March 31, 2009, it appears that the actual results lagged behind the weighted returns of the benchmarks for each asset class. (The benchmark weighting used for the whole period are those of the so-called “Phase II”

allocation.) Since the Trust Fund's investment choices involved a mix of a major allocation to a passive instrument (U.S. All Cap Core) designed to track index performance, any under-performance would likely be a result of manager underperformance, fees and expenses, the effects of timing of shifts in the strategy, tactical execution of the prevailing strategy or any combination of these factors.

The allowance of third-party contributions to the FSM trust fund, by mutual consent of the FSM and the U.S., was a feature of the Amended Compact. The FSM did not attract any third-party contributors to its trust from fiscal year 2004 through fiscal year 2008.

### Other Risks and Vulnerabilities

#### ***Poor Governance***

Internal governance issues contributed significantly to FSM's failure to promote economic development from FY 2004 through FY 2008. The lack of coordination between FSM national and state governments and poorly mobilized nationwide public information and support limited the effectiveness of reform efforts. The institutionalization of strategic planning as a way to guide decision-making was nonexistent. The availability of planning expertise, especially necessary to link reforms to development goals, was in short supply.

#### ***Poor Statistical Capacity***

During the five-year reporting period, basic national and state capacities to generate and maintain economic and fiscal information and to fulfill the country's reporting obligations under the Amended Compact were weak. The FSM lacked the internal systematic capacity to collect and maintain data on the components of the national and state economies, on demographics, on employment and unemployment or on migration, all elements essential to sound planning and policy development. The FSM depended instead on expatriate advisors and regional consultants to carry out most of these basic functions.

## **EFFECTIVENESS OF U.S. FINANCIAL, PROGRAM AND TECHNICAL ASSISTANCE**

### **The Education Sector**

#### **Compact Objectives, Uses and Budget Trends**

Improving educational delivery and outcomes are among the primary goals of the Amended Compact. The FSM designated education as its top priority for financial assistance during the five-year reporting period.

The education sector received the largest share of U.S. grant funding under the Compact during the five-year reporting period. Ninety percent of Compact funds are expended at the state government level, and 30 percent of the total funding was allocated to the education sector. Uses of the money varied. Each state employed different approaches to educational service delivery and therefore produced different results. Starting in 2005, in addition to U.S. Compact funding provided in Compact section 211 (a), the United States made available a Supplement Educational Grant (SEG) of approximately \$12 million a year. A majority of these SEG funds went toward early childhood education formally known as the Head Start Program. United States SEG funding will be discussed more fully later in this section.

Funding for the FSM national government supported technical assistance, student testing and curriculum evaluation activities of the Department of Education, and provided general support to the College of Micronesia (COM), the nation's only institution of higher learning. COM's share of the annual education grants proportionately supported the main campus at Palikir, on Pohnpei, and four satellite campuses (one in each state).

#### **Educational Developments in the First Five Years of the Amended Compact**

The FSM national and state departments of education struggled to identify goals and objectives for the sector and had trouble establishing priorities for comprehensive strategic education plans to improve the quality of basic education.

#### ***Data Collection Reporting***

In 2004, JEMCO required the FSM to report annually on a set of 20 indicators of educational progress. Underlying the requirement was the assumption that data systems, developed during the initial Compact period through the U.S. Department of Education Freely Associated States Education Grant (FASEG), were functional. That initial assumption was overly optimistic. Although the grant purchased data hardware and software, the departments lacked adequate staff capacity to collect, input and analyze data.

From 2005-2008, the FSM made steady progress toward building the capacity to produce the required report. Whereas the 2005 report contained data on only seven of the required twenty

indicators, the 2009 submission reported on all 20 and included analysis and commentary on data validity and reliability.

***Increased Access to Education***

The FSM Education Act officially mandates formal education for children from ages 6 to 14. At the time of the Act’s passage, high school was optional because of limited classroom space. However, the four states deemed universal education through grade twelve to be desirable in 2004 and attempted to open both elementary and secondary schooling to all students.

FSM’s 2005 report on educational indicators listed 16 secondary schools. The 2009 report listed 28, a 75 percent increase in the number of opened high schools. None of the high schools was a Compact infrastructure project.

While the number of available high schools grew, data showed an 11 percent decline in enrollment. In 2005, there were 7,958 high school students enrolled. In 2009, the number dropped to 7,062. Having more high schools made attendance convenient but did not lead to an automatic rise in student enrollment.

Access to elementary education was a challenge throughout the FSM. Out of the 252 elementary schools in the nation, 106 (42 percent) had enrollments below 50 students. Of these schools, 102 were in the outer islands of Chuuk and Yap, where school consolidation would be impractical. The logistics of staffing, supplying and operating small schools were difficult, particularly in those two states.

***Declining Student Enrollment***

Student Population	2005	2009	# change	% change
FSM total	34,601	30,752	-3,848	-11%
Chuuk	17,580	14,930	-2,650	-15%
Kosrae	2,532	2,043	-489	-19%
Pohnpei	11,277	10,629	-648	-6%
Yap	3,212	3,150	-62	-2%

Student enrollment dropped by 11 percent in the FSM in the five-year reporting period. Chuuk and Kosrae saw the largest percentage declines. Chuuk’s student population decline comprised 69 percent of the total; Pohnpei, 13 percent; Kosrae, 13 percent; and Yap, 2 percent. The decline in student enrollment most likely is attributable to FSM out-migration.

### ***Low Student Achievement***

Standardized student achievement test score results were not encouraging. However, the exams administered by the FSM national government from 2005 to 2008 were of questionable validity since they included content that was never taught. For example, calculus was not a part of any FSM curriculum but was a component of the test given to grade 12 students.

The FSM's National Department of Education addressed the testing issue by setting standards in language arts, math, and science and developing standards-based assessments in language arts for grades six, eight, and ten.<sup>4</sup>

In May 2009, the National Department of Education administered English reading tests linked to the FSM standards-based curriculum that it developed in 2007 and 2008, yielding the first reliable gauge of student achievement and establishing benchmark data. The data shows room for improvement: thirty-four percent (34%) of grade six students scored minimally competent to competent, meaning that 66 percent did not meet basic reading expectations for their grade. For grade eight, 32 percent were minimally competent to competent. Only 10 percent of 10<sup>th</sup> graders met minimal to competent expectations in reading. The higher number of students who met reading standards at lower grades indicates that more elementary students developed adequate literacy skills than did students in higher grades. On the positive side, better skills development in younger children should result in higher success rates as they progress from grade to grade. Another positive development is that as teachers and teacher-trainers become more conversant with standards and standards-based assessments, they should be able to focus on the specific teaching and learning needs that the new assessments identify.

### ***Discouraging Student Drop-out Rates***

Dropout rates during the five-year reporting period were difficult to calculate; however, the comparison of cohorts, i.e., the number of students who move from one grade to the next, indicated significant drop-out rates. Declines in enrollment were largest between grades 4 and 5; among middle school-age students at grades 7 and 8 and grades 8 and 9; and in high school at grades 9 and 10 and again at grades 10 and 11. (Students who stay in school through grade 11 tend to finish grade 12.)

The expectation among educators is that students at grade 4 should have adequate literacy skills to learn on their own. Those without skills are at-risk of dropping out. In the FSM, middle schools (grades 8 and 9) showed high drop-out rates as do many U.S. schools; however, the ongoing attrition between high school cohorts was particularly high in the FSM.

### ***Declining Numbers of COM Graduates and Unknown Impact of Scholarship Funding***

The College of Micronesia (COM) annually received \$3,800,000 from the Compact's Education Sector Grant and just over \$684,000 from the Supplemental Education Grant. Documents from COM indicated that those amounts comprised 37 percent of the college's operating expenses.

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<sup>4</sup> Standards based assessments are currently in development for math and science.

The remaining 63 percent of the college’s budget primarily came from tuition payments via PELL grants.

Data on college graduation is one of FSM’s 20 educational indicators. COM provided data for 2005 but not again until 2008. The trend indicates a decline in the number of students who completed their program of studies toward an associate degree but, by itself, the percentage was not meaningful. The more useful indicator instead would be a comparison of enrollment and graduation rates.

Year	Degrees Awarded	% change from '05
2005	168	
2008	138	-18%
2009	121	-28%

In addition to providing COM with operating support, the FSM national government and the four states allocated Compact education grant dollars to scholarships. In a typical year, the FSM awarded over \$2.7 million to students to attend post-secondary institutions. Over the five-year reporting period, the total came to over \$13.5 million. FSM did a poor job of tracking scholarship recipients and had no information on how many degrees resulted from this substantial outlay of scholarship money.

***Focus on Teacher Certification***

The National Department of Education prioritized teacher certification as a means of improving the quality of teaching and learning. From 2005 to 2009, FSM saw a slight increase in the number of teachers who possessed the required Associate of Arts (AA) degree for certification. Pohnpei State improved the most in this regard and Kosrae maintained comparatively high percentages of teachers with degrees.

Chuuk and Yap States faced logistical challenges in upgrading their teacher corps from 2004 to 2009. All FSM states depended on COM as their primary provider of credited coursework leading to certification, but the College had limited ability to provide outreach to the outer islands of Yap and Chuuk where most of the uncertified teachers live and work.

	No Degree		AA or higher	
	2005	2009	2005	2009
FSM	699 (38%)	683 (35%)	1147 (62%)	1291 (65%)

Chuuk	457 (56%)	423 (47%)	423 (44%)	478 (53%)
Kosrae	18 (8%)	8 (4%)	196 (92%)	192 (96%)
Pohnpei	96 (16%)	29 (6%)	483 (79%)	486 (94%)
Yap	128 (53%)	223 (59%)	106 (47%)	153 (41%)

Another factor that impeded progress in teacher certification was the lack of control over personnel matters by state departments of education. Hiring and firing decisions were the purview of the Public Service Commissions, none of which used the AA degree as the entry-level qualification for teaching positions. Hiring was also subject to political interference, leaving school systems with the task of upgrading unqualified teachers.

***Problematic Teacher Attendance***

Reported teacher attendance was stated to be 91 percent, but this figure is overly optimistic. The FSM officially gleaned attendance data from payroll information since most schools lacked formal time-keeping systems. Because teachers received their paychecks from centralized finance departments, attendance data reflected salaries paid out rather than actual attendance. Further, with teacher hiring and attendance policies outside the direct control of departments of education, the departments had little authority over their personnel. Public Service Commission guidelines protected teachers whether they taught or not, taking away the right of education administrators to demand accountability and adherence to departmental policies.

***Ineffective Integration of Programs Funded By the Supplemental Education Grant (SEG)***

The FSM, at both state and national levels, took a status quo position on programs rolled into the SEG. The departments did not redesign their plans to enhance overall educational systems but retained the elements of the former grant programs as independent activities under the umbrella of education. The departments also did not reassign or retrain the staff who worked under the former grants, leading to the creation of numerous duplicative positions. The addition of isolated projects into education departments flattened the organizational structure, complicated management and led to opaque lines of accountability. Beginning in 2007, some of the education systems began looking at using United States SEG funding more flexibly but none considered reorganizing the programs into a more manageable organizational framework.

**Moving Education Forward**

***Limit Uses of Amended Compact and SEG Grants to Address the Problem of Rising Expectations During a Time of Decreasing Funds***



Compact support for elementary and secondary education needs to hold to the clear definition memorialized in the Amended Compact: "Emphasis should be placed on advancing a quality basic education system." Further, a policy statement is necessary to define "basic education" in the following terms:

*For purposes of Compact support, basic education consists of kindergarten through twelfth grade standards-based instruction in four core academic areas; language arts (English and vernacular), math, science, and social studies with integrated, locally relevant career and technical education.*

The meaning of "basic education" was made explicit so that FSM's education systems do not expect U.S. Compact funding to support all the educational services they might like to provide.

The FSM should be encouraged to explore other funding resources to address food, transportation, art, music, and physical education. At the time the Amended Compact came into force, the FSM Education Act only mandated instruction from ages 6 – 14. In 2008, all states offered universal early childhood through grade 12. This expansion was ad hoc but achievable. However, the desire to add adjunct food and transportation programs and services continues to grow despite the fact that mandatory decreases in Compact grants leave room for little more. A three-year phase-out might be appropriate. Similarly, the static level of SEG funding cannot accommodate more than the programs it currently funds (primarily early childhood education, curriculum development and assessment, vocational and career training, and teacher training).

FSM's chief executives issued budget calls that call for zero-growth. Consequently, education departments forwarded very similar budgets year after year that barely maintained salaries and supported recurring expenses. Politically popular efforts to implement school lunch programs and to provide transportation services nonetheless appeared in the budgets and affected the sustainability of the FSM's educational offerings. Although initiated through local legislatures, local funding did not cover these ancillary services. Food and ground transportation are increasingly expensive, and continuing them through Amended Compact funds takes increasing amounts of money away from basic classroom teaching.

### ***The Supplemental Education Grant Should Be Maintained***

The SEG took the place of several domestic programs that the U.S. eliminated for FSM through the Amended Compact. The law added an amount equivalent to the sum provided through the Amended Compact's new financial assistance package. However, delivering the funding was complex. (The law requires a memorandum of agreement between the U.S. Departments of the Interior, Education, Labor, and Health and Human Services. The U.S. Department of Education must insert the SEG into its annual budget request. Only after passage of the appropriations act, can the Department convey the funding to the Office of Insular Affairs for disbursement to the FSM.) During 2004-2008, the process resulted in a severe and confusing lag between the beginning of the fiscal year and the actual release of SEG funds. The release of

United States SEG funding sometimes occurred well after the start of the fiscal year. Planning for the efficient and seamless use of both resources was nearly impossible.

Beginning in FY 2010, OIA awarded FY 2009 SEG and sector grant funds simultaneously. In an unexpected way, the year-long gap in SEG use has a benefit: FSM education systems will have their two Compact funding streams from the U.S. for education arrive at the same time. This confluence will enable comprehensive budgeting to occur.

It would be a mistake to dismantle SEG and return to U.S. domestic programs, as has been suggested. The “cashed out” programs were often at odds with the FSM’s social and educational context. For example, the results of outcome and participant tracking measures required by the FSM’s Workforce Investment Act grant, showed little benefit. Projects to place young people in jobs to explore work options devolved into distributing summer pocket money for participating youth. Similarly, Head Start did not produce longitudinal data correlating the program to increased academic success. After decades of Head Start interventions, FSM student test scores remained low regardless of prior participation in the program.

With the supplementary U.S. funding made available through the SEG, the FSM has begun to develop more locally relevant projects. Both Chuuk and Pohnpei have used former Workforce Investment Act (WIA) funds to develop partnerships with the Guam Trades Academy to prepare their students for jobs resulting from the Guam military build-up. The flexibility with which they have used the funding would not be possible under WIA regulations.

The reaction to SEG funding delays and lengthy administrative handling should not evoke a return to the former status, but stimulate a commitment to work toward better integration of the programs. This integration could benefit from information already gathered through staffing and organizational analyses required by special grant conditions applied to the FSM’s FY 2005 grant award and other similar activities.

The most beneficial change to SEG would be in terms of the funding mechanism. The SEG is an integral supplement to the Amended Compact’s education sector, but is funded with an annual discretionary appropriation through the U.S. Department of Education. The annual appropriations have been less than the level authorized by PL 108-188. (\$12,230,000 with partial inflation adjustment.)

***Budgeting Roles of the FSM Education Departments, FSM National and State Legislatures, and the U.S. Need Clarification***

Local political and educational systems inevitably collide in an environment where 95 – 100 percent of the funding for education in the FSM comes from the United States. The Amended Compact stipulates that the Education Sector money take the form of annual grants, requires that recipients adhere to planning and reporting requirements inherent in that funding method, and calls for regular project-based planning and evaluation between the OIA Grant Manager and education system administrators. However, as experienced during 2004-2008, national and local legislatures expected to exert control Amended Compact grant moneys as if the moneys were local revenue. These legislatures required that the education departments

submit line item budgets where budget review committees exercised the authority to redistribute funding.

Local budget review processes are opaque and tend to generate intra-governmental tension. Education representatives presented their budgets to legislators but were not involved in deliberations. Legislative revisions were faits accomplis. To appeal changes, educators typically contacted the U.S. grants manager, placing him in the awkward position of contradicting legislative decisions or agreeing to dismantle what had been sound planning. OIA generally recommended reinstating budgets to their original format but this action provoked legislative accusations of micro-management and interference in sovereign affairs.

Given the limited period of Compact grant assistance, it makes sense to work toward a reasonable, mutually acceptable budgeting process. Budget and plan development may need to occur earlier to allow all the stakeholders adequate time for input. Education administrators should have the right to defend their budget and appeal any changes within their legal frameworks. A clear and mutually understood timeline seems like a workable step to easing inter- and intra-governmental tensions.

### ***Reexamine Fiscal Practices and Subsidies for Transportation and Electricity for Schools***

Weak internal fiscal procedures negatively affected the delivery of education and were a source of frustration in the FSM. All education expenditures were routed through a state finance office, making for cumbersome and duplicative approvals and processing. The lack of communication and overlapping authorities between education and government budget offices hampered fiscal operations. A way to resolve this problem would be to develop a clear set of audit expectations that would guide both education and budget offices as they process transactions. Processing must be streamlined and all appropriate education and finance staff trained in uniform procedures.

Transportation in the FSM, where every education system except Kosrae's depends on ships to service outer islands, is another serious problem. None of the state governments maintained regular schedules or made timely vessel repairs. Yap State Government in particular expected the Department of Education to pay a share of operating costs disproportionate to the use education made of the ships. While education paid for the ships, it had no voice in scheduling. The lack of regularly scheduled ocean transportation increased the difficulty in getting supplies and materials to schools, providing on-site supervision and training, and convening teachers for training. Collaborative solutions to ship-transit problems are crucial to providing equitable education to outlying islands.

Electric utilities on the main islands of the four FSM states functioned erratically because of outmoded or poorly maintained equipment and cash shortfalls. International donors are funding solar installations at many outer island schools but not in coordination with the education departments. Educational technology has the potential to bring new and less expensive learning resources to schools but its use is dependent on a reliable source of electricity. Alternatives such as solar power need exploration and collaboration.

### ***Scholarship Policies and Tracking Need Improvement***

Discussions between the FSM national and state education systems should occur to review scholarship policies. Reports, incomplete as they are, indicate that scholarships resulted in few completed college degrees. The FSM needs to reexamine and establish consistent policies on the extent to which Compact funds should support post-secondary scholarships, including instituting a percentage cap on budgeted amounts. The current de facto policy of spreading the money among as many recipients as possible also may need revision.

Follow-up on scholarship recipients was lax except in Yap, but it was common knowledge that those few individuals who actually attained a degree seldom returned home. If scholarships could support incumbent workers, that is, people already employed but in need of educational upgrading, the success rate might improve and the willingness of people to stay and work at home increased. Additionally, the strain on education budgets may be less if teachers received scholarship support. This inclusion would have the net effect of improving teacher quality.

### ***JEMCO Must be Concerned with the Sustainability of FSM Post-Secondary Education***

COM infrastructure projects are not necessarily pivotal to accreditation by the Western Association of Schools and Colleges (WASC) Accrediting Commission for Community and Junior Colleges. The primary aim of WASC is to insure the quality of curriculum and instruction and the equity of facilities and services to students. It does not monitor student outcomes nor does it question the long-term sustainability of an institution. WASC does expect, however, COM to have a strategic plan and once that plan is in place, that sufficient resources will be available for execution.

COM has repeatedly reaffirmed its commitment to maintaining all four of its state campuses in addition to the national campus at Palikir in Pohnpei. It was because of that long-standing operational policy that WASC threatened to pull accreditation unless COM could provide an acceptable facility for the Chuuk COM campus. In other words, WASC held COM accountable for its five-campus policy. WASC never told COM it must have a five-campus policy nor did it question COM's rationale. Rather, because the policy was in place, WASC expected COM to follow through and provide all five sites with facilities and services.

COM has itself backed into similar accreditation problems through its decision to have vocational training at every campus. It could decide to have magnet vocational sites or even dispense with vocational and career training altogether. The coursework COM provides is an internal decision and not something mandated by WASC, but once decided the accrediting body must focus on the quality of curriculum, instruction, and facilities to determine whether the facilities are adequate and the coursework is credit-worthy.

JEMCO should evaluate COM's campus planning in terms of long-term sustainability. It also should determine whether U.S. Amended Compact infrastructure funding should go to repairing and reconstructing COM's state campuses or if U.S. assistance would be more effective if used elsewhere.

## ***FSM Education Systems Must Give Attention to Community Involvement***

A cross-cultural conflict exists in FSM with respect to western-style educational systems. Parents play little part in the educational process due to cultural confusion over how to address western institutions. Years of educational research validate the common-sense notion that schools are more effective when there is parental involvement, but efforts to do so are never easy. Perhaps even more difficult is getting parents involved in schools in Pacific island contexts.

There remains a widespread attitude in the FSM that education is a government endeavor. Parents are willing to cede responsibility for providing western-style education to their elected governments. However, they do expect the schools do their job and are often dissatisfied with the results. Voicing their concerns and taking an advocacy stance on behalf of their children are not roles Pacific parents easily can assume. The cultures are hierarchical: one does not criticize those in positions of authority, at least not directly. It would be disrespectful to do so. Nonetheless, each different culture of the FSM has prescriptive ways to express opinions and expectations upwardly to authorities.

Unfortunately, the ways to interact with authorities of higher status have not transferred to education even during parent-teacher association (PTA) meetings. Throughout the FSM, PTA meetings are quarterly meetings where parents pick up report cards and receive certain directives from school administrators. These times are not opportunities for parental input and participation, as is the case in the U.S. Instead, the process is one-directional, from the school to the parents. Similarly, education systems are top-down from centralized offices to the schools. Culturally appropriate communication patterns have not developed to close the loop from parent to school and from school to central administration.

The FSM could benefit from examining the “Cluster PTA” model, a method of engaging communities that has been developed and nurtured in the Marshall Islands. The model helps parents and schools articulate roles and responsibilities, providing everyone an acceptable means of speaking up and down the hierarchy. For the long-range success of education, parents must become more involved. To make sure parents get involved, the FSM education systems must invite them to participate, develop a comfortable means of expressing their concerns, and forge real partnerships.

## **The Health Sector**

### **Compact Objectives, Uses and Budget Trends**

The Amended Compact directs U.S. health sector funding to support the FSM’s delivery of preventive and curative care and environmental health services, and the acquisition of material and human resources needed for improvements. It emphasizes the establishment of sustainable funding mechanisms to maintain services and programs at appropriate levels after U.S. financial assistance ends in 2023 and to reduce reliance on medical referrals abroad.

### **Grant Totals, Proportionate Shares and Uses**

The FSM received \$15,442,116 for its first Compact health sector grant in FY 2004. The four state health departments and the national government's Department of Health and Social Affairs (DHSA) shared the amount according to allocations requested by the FSM and approved by JEMCO. By FY 2008, the FSM's grant award rose to \$17,741,499.

Over the five-year reporting period, the FSM spent its grant funds to support recurring operating expenses for primary and secondary medical care, off-island tertiary or specialized care referrals, dental health, mental health and substance abuse services, information systems development and, to a lesser extent, public health programs. The largest proportion of Amended Compact assistance went to Chuuk at 39 percent. Pohnpei received 30 percent; Yap, 15 percent and Kosrae, 11 percent. DHSA received 5 percent of sector grant funds awarded from 2004 to 2008.

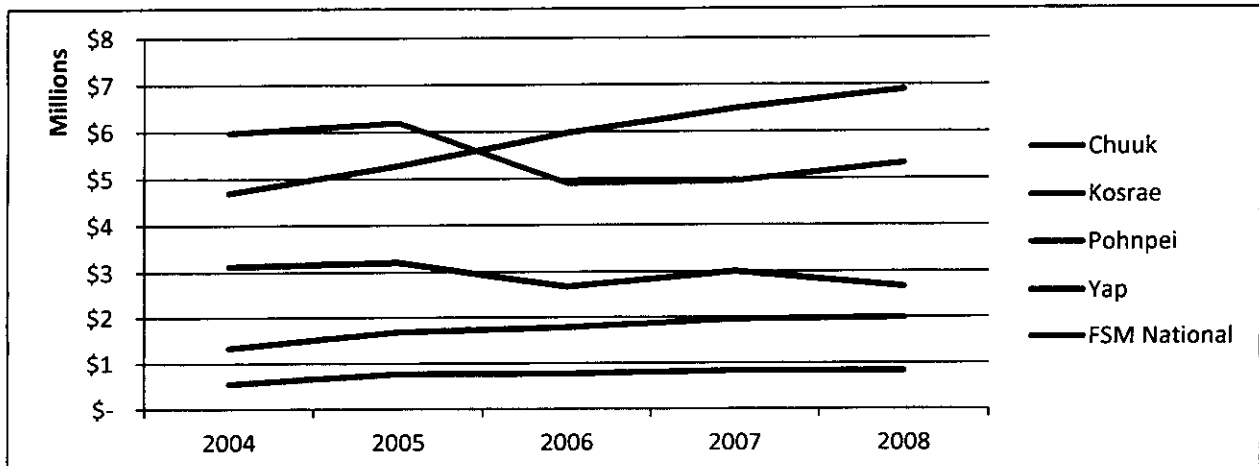
### **Redressing Prior Deficiencies**

The designation of the health sector as a top priority by the Amended Compact has meant greater attention and more dollars going to the FSM health departments than in the years immediately preceding the implementation of the Amended Compact. Kosrae's annual health appropriation, for example, grew from approximately \$900,000 in FY 2003 to \$1.3 million in FY 2004. Other state budgets also saw similar dramatic increases in the first year of implementation. Budgetary growth in all states continued through FY 2006.

All states used their Compact sector grant funds to cover recurring expenses but they also began investing their resources in training, making small repairs to their long-neglected hospitals, and fixing or replacing biomedical equipment. The health departments also brought additional staff on-board to replace those employees who were lost through attrition or budget decreases during the waning years of the original Compact. Part of their effort involved reviewing personnel pay policies and schedules and incrementally adjusting health worker salaries held static for years.

The chart below shows the growth trend of Compact health sector funding in the four FSM states and for DHSA from FY 2004 through FY 2008:

Amended Compact Health Sector Funding from the U.S. to FSM Recipients, 2004-2008



Although the FSM's overall funding for direct health expenditures increased during the five-year reporting period, it did not keep pace with inflation. Budget preparation instructions from state finance offices during the five-year reporting period excluded annual increases in the price of medical supplies, pharmaceuticals, medical equipment, freight and energy (electricity and fuel) even though these costs increased each year.

After four years of catch up, the FSM found itself on familiar grounds in FY 2008: falling or flattening levels of health care funding. Maintenance of effort became the *raison d'être* of budget planning by Yap and Pohnpei as their operating budgets fell below their FY 2004 levels. Kosrae and Chuuk continued to see their budgets grow, but there too, health officials expressed a vague uneasiness for the future. They understood that there would be a period of belt-tightening ahead because of the impact of decreases in Compact grants, but did not know when that would occur.

### ***Personnel and Non-Personnel Costs***

By necessity, labor costs for all FSM state health departments were substantial because the category includes all direct and indirect hospital service providers, all primary care personnel at outlying clinics and dispensaries, public health staff and health administrators and program managers. From 2004 through 2008, the FSM spent approximately 47 percent of Amended Compact health dollars on salaries, fringe benefits, overtime, and standby pay for the nation's 956 health employees. (This amount was less than the 53 percent spent on personnel by U.S. hospitals alone in 2008.) Adjustments to the salaries of doctors, nurses, and certain categories of paraprofessionals who received lower pay than their counterparts in health departments in other FSM states, were necessary for equity and to aid in recruitment and retention.

Non-personnel recurring operational expenses accounted for 53 percent of health department spending. More than a third of the amount went to "other current expenses" (OCE) such as communication, fuel for vehicles and backup generators, offices supplies and materials, printing, utilities, medical supplies and pharmaceuticals.

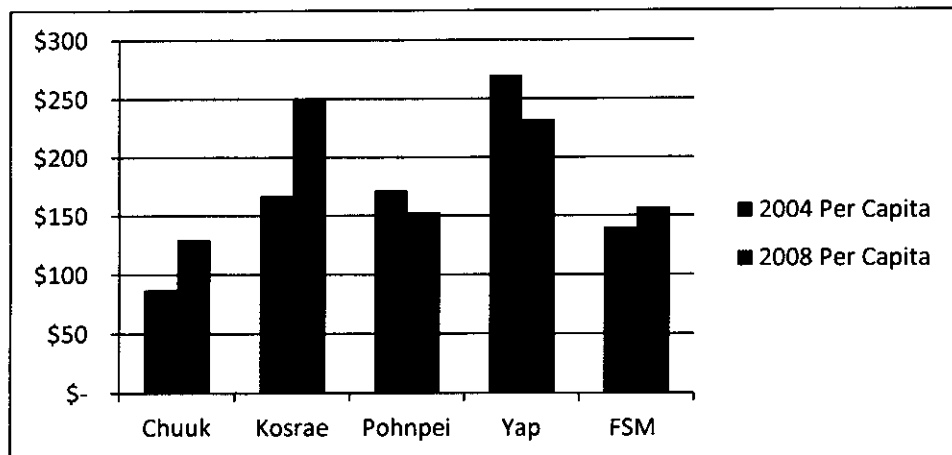
The FSM's mandatory infrastructure maintenance fund did not cover repair and maintenance of health facilities. Instead, these expenses were part of OCE, carved-out by reducing travel (less than 2.4 percent of total spending) and other recurring costs. Similarly, fixed asset purchases to replace broken and outmoded equipment and patient furniture were carve-outs or, as happened in 2008, mandated by JEMCO. While necessary, the redirection of funding to cover OCE shortfalls affected the health departments' ability to direct Amended Compact assistance to improve direct patient services and programs.

### ***Per Capita Health Dollars***

Total health expenditures grew at an average annual rate of 2.6 percent between 2005 and 2008, while GDP grew at a lower rate of 1.1 percent. In 2008, the FSM spent \$304 per capita on health from all sources. The table below shows the per capita spending of Amended Compact dollars on direct health care services and programs since FY 2004. (The table excludes the

national government’s Department of Health and Social Affairs as it is does not provide direct health care.)

Change in Per Capita Amended Compact Health Spending, 2004-2008



From 2004 through 2008, per capita spending of U.S. Compact assistance increased in Kosrae and Chuuk, the two states that arguably had lower health budgets during the period of the original Compact. Chuuk, with the lowest 2003 state budget based on population and need, saw its per capita spending increase from \$88 in 2004 to \$130. Kosrae’s spending per person grew from \$168 to \$250. Pohnpei’s spending jumped to \$172 in 2004 but fell to \$153 in 2008. According to fiscal projections, the amount Pohnpei State spends on health care will decrease far below its 2004 level. This downward trend is alarming since Pohnpei serves as the national capitol. Hospital services, personnel expertise and program coverage are comparatively more advanced there than in its sister states.

***Tempered Effects of Early Budget Increases***

FSM’s limited workforce capacity to plan for and utilize new equipment, supplies and personnel efficiently tempered many of the effects of increased spending one would expect to see. Management systems for personnel, medical supply inventories, equipment and facilities maintenance and procurement were archaic and dysfunctional. Efforts to make improvements in, for example, purchasing drugs and supplies and hiring were not amenable to quick fixes or immune from political preferences and directives.

**Health Sector Performance**

***Progress in Reaching Five-Year Performance Targets***

FSM’s health directors unanimously agreed in 2004 to measure the overall performance of the states by tracking fourteen indicators tied to the country’s strategic national plan. These indicators quantify the efforts of the nation to improve diagnostic and treatment capacity, to



ensure the provision of services to geographically dispersed populations, and to serve as internationally accepted markers of a community's health. They chose performance targets deemed to be achievable at the end of the first five years of financial assistance and agreed to evaluate the indicators in five-year intervals to determine if substitutions or revisions to the indicators are necessary and if targets need resetting. (The first review will occur in FY 2010.)

For the FSM, health status outcomes will lag behind improvements made to programs and to service delivery. Changes in functional status and outcomes, measured in life years saved or gained, will take time to become evident and will depend on successful interventions to alter people's behaviors and their perceptions of the value of lifestyle modifications. Improved results will occur when people in the FSM community, many of whom still seek care only when sick, come to understand the personal benefits of early intervention, compliance, and health maintenance and promotion. Seen in this light, the significance of data in a given year and yearly fluctuations are less important than trends that emerge from 2004 through 2008. These tendencies indicate quantifiable positive changes that are beginning to emerge in services provided by the FSM.

The following is a summary of progress made by the FSM in meeting its 14 health indicators from 2004 through 2008:

**Indicator #1: Decentralize primary care to homes and dispensaries**

<u>Decentralize primary care to homes and dispensaries</u>	
2004 baseline:	81,144 visits (nation-wide)
Targeted outcome:	By 2010, increase visits by 20%
FSM 2008 Status:	Sudden unexplained decline (74,800)

This indicator is a function of the FSM's goal of making health care services more accessible to people in villages and municipalities on the main islands and especially to outer island communities. Until 2007, all four states reported increased community-based encounters. In 2008, both Pohnpei and Chuuk reported precipitous drops but for unexplained reasons.

Pohnpei's numbers declined from 76,276 in 2004, to 50,811 in 2006, and to 21,232 in 2008 even though the community historical use of the dispensaries had been steady. In Chuuk, decentralized visits had been on the upswing but the difference between 2007 and 2008 showed an unaccounted for decline of over 20,000 encounters. Chuuk's very mobile lagoon and outer-island populations and the increase in out-migration may have played a role. In addition, dispensaries often have the reputation of being closed, lacking medications, and missing health assistants. Both states' departments understood this one-time decline seemed aberrant and are investigating possible reasons.

Kosrae has purchased a mobile clinic to visit each village on a scheduled basis to bring primary care providers and public health programs to the community. Yap Island’s model system of five satellite community health centers improved access to care dramatically.

**Indicator #2: Decentralize primary care by reducing patient encounters at hospital clinics**

<u>Decentralize primary care by reducing patient encounters at hospital clinics</u>	
2004 baseline:	90,273 encounters
Targeted outcome:	By 2010, reduce by 20%
FSM 2008 status:	61,173 encounters

Indicators #1 and #2 are mirror images in that a decline in outpatient visits (hospital clinics) should accompany an increase in dispensary visits for primary care. Over the five-year reporting period, outpatient and emergency room visits were lower in Pohnpei, Yap and Chuuk. Kosrae’s numbers of inpatient visits were unaffected since there are no dispensaries and patients come to the hospital for primary care.

**Indicator #3: Increase immunization coverage of 2-year old children**

<u>Increase immunization coverage of two-year old children</u>	
2004 baseline:	84% covered
Targeted outcome:	90% covered
FSM 2008 status:	76.75% covered

Over time, both Yap and Kosrae have achieved better coverage. In 2008, Kosrae reported that 100 percent of two year olds received full immunization coverage. Yap’s coverage went from 79 percent in 2004 to 98 percent in 2008. The slippage in the nation-wide rate was attributable to Chuuk, whose 2008 rates fell well below its 2004 baseline of 80 percent, and because Pohnpei altered its immunization schedule to accommodate an added vaccination.

In Chuuk, immunizations increased to 93 percent in 2005 due to mass inoculations following a measles outbreak but fell to 80 percent in 2007 and 54 percent in 2008. The poor results are primarily the result of unreliable transportation to the outer islands, which affected the health department’s ability to deploy public health teams on a regular basis. In Pohnpei, the coverage rate remained steady at about 80 percent between 2004 and 2007 but dropped precipitously to 54 percent in 2008. The explanation given was that the Department of Health Services added HIB3 vaccines to its immunization protocol and therefore followed new schedules.

#### Indicator #4: Essential drugs and supplies in stock

<u>Essential drugs and supplies are in stock</u>	
2004 baseline:	63% of all calendar days
Targeted outcome:	By 2010, 80% of days
FSM 2008 status:	85% of days

The essential drugs and supplies selected for tracking were ORS (oral rehydration salts), combo OCP (combination oral contraceptive), amoxicillin (antibiotic), IV chloramphenicol (antibiotic), glyburide (anti-diabetic), atenol (anti-hypertensive) and HCTZ (anti-hypertensive and diuretic).

JEMCO instituted measures to safeguard state pharmaceutical and medical supply funding levels from 2006 through 2008 to fend off arbitrary funding reductions taken during the legislative appropriations process. All states reported progressively improved inventories. Yap went from a baseline of 87 percent of all days to 90 percent, Chuuk from 83 percent to 90 percent, and Pohnpei from 30 to 100 percent in 2008? Kosrae's rose from a baseline of 53 percent in 2004 to 60 percent in 2008.

#### Indicator #5: Biomedical equipment is functional

<u>Biomedical equipment is functional</u>	
2004 baseline:	70% of all calendar days
Targeted outcome:	By 2010, 80% of days
FSM 2008 status:	79% of days

Laboratory tests selected for tracking included sodium, potassium, ALT (for liver enzymes), bilirubin, and creatinine.

Equipment maintenance and quick repairs remained shortcomings but purchases of new chemistry analyzers gave this indicator a boost in all FSM states except Kosrae where the capacity for laboratory testing remained the same at 75% of all calendar days. Yap reported that tests were continuously available from 2006 to 2008.

#### Indicator #6: Reduce average length of hospital stay

<u>Reduce average length of hospital stay</u>	
2004 baseline:	6 days
Targeted outcome:	Less than 7 days
FSM 2008 status:	6 days

This measure is a de facto indicator of the effective management of hospitalized patients and the chronicity or acuity of conditions that require longer stays. Keeping the average number of hospitalized days to some minimum number is also a cost containment method.

**Indicator #7: Reduce infant mortality**

<u>Reduce infant mortality</u>	
2004 baseline:	19/1000 live births
Targeted outcome:	By 2010, less than 16/1000
FSM 2008 status:	17/1000

Infant mortality is a major marker of health care adequacy and impoverishment. The FSM's overall rates have fluctuated annually given the country's very small population size and even smaller number of deliveries in a year (one infant death will inflate the rate dramatically). The national rate in 1999 was 19.5/1000. It peaked in 2003 to 22.6/1000 and again rose in 2007 before declining to 17/1000 in 2008. Nonetheless, FSM's relative low ranking places it above that of the Republic of the Marshall Islands and many of its small Pacific island country neighbors.

The improved average national rate obscures the performance of two FSM states with greater infant deaths and the most far-flung outer island populations. Chuuk's 2004 baseline was 20/1000 but infant deaths rose in both 2007 and 2008 to, respectively, 28.5/1000 and 29.3/1000. Yap's 2004 baseline was 26/2000. In 2007, the rate jumped to 33.2/1000. The major causes of infant mortality are diarrhea and respiratory infections.

**Indicator #8: Mental illness is reduced**

<u>Mental illness is reduced</u>	
2004 baseline:	17/107,786
Targeted outcome:	By 2010, reduce by 10%
FSM 2008 status:	1/108,026

No FSM state employs a licensed psychologist or psychiatrist and diagnostic specificity is impossible without visiting consultation. The selected indicator of completed suicides is a proxy under these circumstances and easily measured. Once all too common among young Micronesian men, the rate of suicides has dropped sharply in all FSM states.

**Indicator #9: Increase the number of individuals enrolled in a health insurance plan**

<u>Increase the number of individuals enrolled in a health insurance plan</u>	
2004 baseline:	33,018
Targeted outcome:	By 2010, increase enrollment by 10%
FSM 2008 status:	34,465

In 2008, approximately 32 percent of FSM's population enrolled in MiCare, the national government's insurance plan open to state government employees, and in the Chuuk Health Care Plan, the only state-run health insurance program in the country. The Amended Compact paid for the care of uninsured and under-insured patients referred out-of-country from 2004-2008 by hospital medical committees who evaluated appropriateness of diagnosis, prognosis and survivability on return. Whereas insurance payments added to the hospitals' revenue, subsidized referrals were a drag on budgets irrespective of the use of less costly tertiary facilities in the Philippines.

Although health insurance capitation (a set amount of money negotiated to cover the care of insurance subscribers), and fee-for-service payments to hospitals are a viable means to finance state-run health care and support service improvements, MiCare has not marketed its plan to become the single insurer of all FSM residents. One of the principal drawbacks is how premiums would be paid and/or subsidized since many FSM residents fall below the poverty line. (Approximately 26 percent of households fall below the poverty line.)

Yap and Pohnpei state governments considered developing their own insurance plans, but small-risk pooling and financing hurdles delayed enactment. The only state that has moved forward on its own is Chuuk. Its program is employer-based, not universal, and state government employees make up the largest pool.

With MiCare and Chuuk plans in force, one would have expected coverage to be more comprehensive from 2004 through 2008, but that did not happen. Reduction-in-force actions taken by Kosrae and Chuuk may have reduced the numbers of eligible government employee enrollees.

**Indicator #10: Reduce off-island medical referral costs in all states**

<u>Reduce off-island medical referral costs in all states</u>	
2004 baseline:	Average of 12.25% of total state health care budgets
Targeted outcome:	By 2010, reduce to less than 10% of state's health expenditures
FSM 2008 status:	Average of 8% of total state health care budgets

In the years preceding the Amended Compact, it was common for off-island medical referrals of the uninsured to cut into the states' operating budgets by 30 percent or more. Patients were sent to high cost facilities in Hawaii and to Guam, not only for tertiary care but also for diagnostic testing and basic hospitalization.

All FSM states have since formalized and tightened the criteria used to determine whether patients would benefit by off-island care. The hospitals have made improvements to on-island diagnostic and treatment capacity and this effort has helped to reduce tertiary care costs. Switching referral sites from Hawaii and Guam to the Philippines (Manila) has been the largest cost-saving measure. Contracted third party administrators in Manila coordinate and monitor patient stays and billings.

Kosrae spent 8 percent of its budget on off-island care in 2004 and lowered the amount to 5 percent in 2008. Yap's expenditures in 2008 consumed 10 percent of its budget, a growth of 4 percent over its baseline. Pohnpei used 21 percent of its budget on higher secondary and tertiary care in 2004 but reduced that expenditure to 6 percent in 2008. Chuuk has set aside a capped amount for off-island referrals of uninsured patients. In 2004, the state spent 14 percent of its annual budget on referral care. The proportion in 2008 fell to 11 percent

Only Pohnpei offers dialysis as a treatment option for kidney failure and end stage renal disease. The other three FSM states opted to close their programs well before the Amended Compact began because of high maintenance and supply costs among other policy considerations. None of the state hospitals has the expertise or can afford to offer non-surgical cancer treatment (intravenous chemotherapy and radiation) but can maintain the regimen of patients who return home with oral medications.

**Indicator #11: Increase the application of dental sealants on 3<sup>rd</sup> grade students**

<u>Increase the application of dental sealants on 3<sup>rd</sup> grade students</u>	
2004 baseline:	58% of all 3 <sup>rd</sup> grade children received sealant applications
Targeted outcome:	By 2010, at least 70% of 3 <sup>rd</sup> grade children receive sealants
FSM 2008 status:	53% of 3 <sup>rd</sup> grade children received sealants

Dental health is the most neglected service in the FSM. Program budgets have been inadequate, outreach difficult, and supplies and equipment minimal.

Sealants offer a relatively inexpensive temporary way to protect the teeth of young school-aged children for whom trips to the dentist usually signal the need for restorative care. Pohnpei, the state with arguably the strongest dental health program, consistently outperformed the other FSM states from 2004 through 2006 with 100 percent sealant coverage. In 2007, however, the

proportion of children covered fell to 53 percent. In 2008, it fell further to 38 percent. Yap's trend was similar. With a baseline of 43 percent, the percentage of children who received sealants rose to 100 percent in 2006 and declined to 77 percent the following year. In 2008, only 54 percent of third graders received sealants. Chuuk began the review period with a rate of 33 percent but was unable to maintain even that percentage. In 2008, only 25 percent of children had sealants applied.

The declining coverage rates portend a worsening of children's oral health status in the FSM. Only Kosrae has consistently improved, covering 58 percent of children in 2004 and upping that proportion in 2008 to 98 percent.

**Indicator #12: Reduce the incidence of diarrheal disease in children**

<u>Reduce the incidence of diarrheal disease in children</u>	
2004 baseline:	5,051 cases
Targeted outcome:	By 2010, reduce incidence by 10%
FSM 2008 status:	4,778 cases

Diarrheal disease in infants and young children, a preventable ailment, is a leading cause of morbidity and mortality where access to clean water, good sanitation, and access to medical care is limited and in areas of poorer nutrition and hygiene. Approximately 37 percent of the FSM population is under 14 years of age. Only 59 percent of the country's residents have access to safe drinking water.

Responsibility for environmental health protection largely resided outside health departmental authority. Kosrae was the only health department that had a potable water-testing program.

In the FSM, diarrheal cases occurred most frequently in Pohnpei and Chuuk. Both states had recent outbreaks of Hepatitis A (Chuuk in 2008 from raw sewage backflows and Pohnpei in 2009). Chuuk's 2004 baseline was 1,561 and the number has remained constant. Pohnpei began the five-year reporting period with 2,389 cases and ended with 1,569. All states saw increasing cases in 2007 and the higher burden has continued through 2008.

**Indicator #13: Reduce the incidence of diabetes-related hospitalization**

<u>Reduce the incidence of diabetes-related hospitalization</u>	
2004 baseline:	838 hospitalizations
Targeted outcome:	By 2010, reduce incidence by 10%
FSM 2008 status:	1,194 hospitalizations

The FSM has yet to develop a reliable system for monitoring the incidence and prevalence of diabetes. Because diabetes and diabetic complications are among the leading causes of acute care admissions throughout the country and are easier to track, the health directors chose reducing the incidence of diabetic hospitalizations as their proxy non-communicable disease measure.

The FSM's diabetic burden is high. Prevalence studies suggest that one in four adults has the disease and it is manifesting at younger ages than before.

The disease and its associated disorders were among the leading causes of death throughout the country during the five-year period under review. Retinopathy, peripheral vascular changes, infections, cardiovascular disease, and renal involvement are common complications. Tuberculosis patients often have diabetes and this co-morbidity may be a factor in compromising the immune systems of these individuals. The \$150,000 in annual U.S. grant funding received by the FSM for diabetes control and prevention (public health) in all four states is inadequate given the magnitude of the problem.

Hospitalizations from diabetes and its complications are increasing rather than declining in all states.

**Indicator #14: All states have functional quality assurance (QA) systems**

<u>All states have functional quality assurance (QA) systems</u>	
2004 baseline:	Established in Yap only
Targeted outline:	By 2010, all states will have functional quality assurance systems
FSM 2008 status:	Pohnpei, Kosrae, and Chuuk now taking initial steps

Quality assurance (QA) programs are important in evaluating patient care and the conditions where it occurs. Patient safety and performance monitoring and improvements are primary objectives.

FSM nurses began QA programs in the 1980s but the effort faltered from a lack of both resources and administrative interest. The effort was insular in that it did not involve hospital units or components other than nursing, and did not extend to public health and primary care. In contrast, the renewed effort undertaken by the FSM from 2004 through 2008 is department-wide and supported by technical assistance from the World Health Organization's Western Regional Office and the Pacific Island Health Officers Association (PIHOA).



The FSM's performance measure calls for wide implementation of the QA program systems process and involves quarterly audits and improvement plans, based on written policy and procedure standards. The program covers the following areas: patient wards, outpatient departments, medical staff, x-ray, laboratory, dental and public health. The FSM national government's Division of Health Services has not implemented a similar initiative for its food safety, local enhancement program and grant-funded management role but has assumed responsibility for monitoring state-by-state progress. Until 2004, DHSA had an implied but seldom invoked role in maintaining quality health services and programs, and health standards.

Pohnpei, Kosrae and Chuuk have agreed to implement QA programs modeled after the one that Yap Department of Health Services instituted in 2004. Staffing and sustainable funding for the programs are concerns. Another hurdle will be the establishment of now-absent written policies and procedures that will cover, at a minimum, management, personnel and the delivery of services.

### ***Health Infrastructure Development***

Health care facilities throughout the FSM are old and urgently need repair. During the five-year reporting period, there was little to no movement on renovation, reconstruction and infrastructure development projects for the sector. This was due to internal FSM decision-making and process issues regarding priority setting and project management, and land titling problems. State deposits of maintenance improvement fund matching funds were delayed and therefore unavailable to the hospitals. Dispensary upgrades and repairs also have remained at a standstill except for small improvements funded by the operating budgets of the health departments.

In Yap and Pohnpei, where there were identified projects, there were numerous delays in executing appropriate conceptual designs. First approved in 2005, work to stage Yap Hospital's renovation project slowed because of budgetary constraints and design modifications needed to fit on the existing campus. Plans for Pohnpei's new public health building met with objections from the Department of Health Services, necessitating re-scoping. The conceptual design will need approval before the project can proceed.

In addition to the difficulty of getting health projects approved and started, the FSM health departments face an even greater hurdle ahead. They will need to identify and capture even larger operational funding set-asides to maintain the new facilities.

### ***Other Indicators of Health***

The FSM has yet to emerge from the dual epidemiologic pattern of chronic and infectious diseases seen in underdeveloped and less developed countries. This situation provides important clues about the challenges facing the four states and the national government and the reality of reduced Amended Compact funding.

Life expectancy is comparatively low: 68 years for males and 71 for females. The fertility rate is high at 4.4 (2008). The crude birth rate is 20.32 (last estimate published in 2007).

Communicable diseases remain the major cause of morbidity in all age groups. Tuberculosis and leprosy are endemic. FSM still has not reached the national leprosy elimination target of less than one case per 10,000 people and its prevalence rate of 40 per 10,000 is among the highest in the Pacific. According to FSM estimates, the country has a tuberculosis prevalence rate of about 100 per 100,000 people, a rate similar to that in other developing countries. However, the disease continues to increase and is a major cause of preventable morbidity and mortality.

In 2000, the FSM declared that it had indigenous HIV infections. Although the true prevalence of AIDS is unknown, there have been thirty-five cases since 1989. Twenty-seven individuals from that cluster have died.

Mosquito-borne diseases are common and linked to environmental sanitation. Zika became present in Yap in 2007. (Zika virus is a mosquito-borne disease first isolated in Uganda and is similar to yellow fever and dengue. The Zika outbreak in Yap marked the first outbreak outside of Africa and Asia.) Outbreaks of mosquito-borne dengue fever in Yap, Pohnpei and Chuuk have occurred since 2004. Cholera re-emerged in Pohnpei in 2002.

Although vaccine preventable disease outbreaks have declined, measles and pertussis occurred in the five-year reporting period, prompting mass stepped-up immunization campaigns after which slippage in coverage occurred.

Diabetes, cardiovascular and cerebrovascular diseases and cancer are major health problems and leading causes of mortality. In the five-year reporting period, deaths from heart disease and strokes among adults aged 25 to 55 years were double those for their counterparts in the U.S. Contributing factors that add to the burden of these preventable “diseases of modernization” are dietary change, inactivity, non-compliance, and ignorance (signs, symptoms, prevention and early intervention).

Leading causes of death among infants and young children were prematurity, newborn sepsis, respiratory infections, under-nutrition and multiple congenital anomalies, including congenital heart disease. Diarrheal disease (waterborne and food-borne) is a major cause of child morbidity.

### ***Successful Response to Two Simultaneous Outbreaks of Multi-Drug Resistant Tuberculosis***

Chuuk’s tuberculosis (TB) incidence rate in 2007 was 127/100,000 or 29 times higher than the U.S. rate for the same year. In late 2007 and early 2008, the Department of Health Services reported its first two cases of documented multi-drug resistant tuberculosis (MDR TB).

MDR TB strains are resistant to at least two drugs (isoniazid and rifampin, the two most effective medications for standard TB treatment) and are difficult to treat. Outcomes are also more likely to be fatal. Treatment of these patients requires at least twelve to eighteen months of expensive second-line antibiotics therapy administered first while hospitalized and then continued on an outpatient basis through labor-intensive direct observed therapy.

The lack of available second-line drugs anywhere in the FSM underscored the seriousness of the emergence of MDR TB. Moreover, Chuuk's geography and limited transportation options, combined with limited TB program staffing, complicated the Department of Health Services' ability to follow through with the protocol for rigorous case-finding and contact investigations.

With investigative and clinical help from the U.S. Centers for Disease Control and Prevention (CDC) in mid-2008, Chuuk identified that it had two simultaneous MDR TB outbreaks on its hands. During December 2007 through June 2008, four patients died, including a two-year-old child. Six patients died without access to second-line drugs. The fatality rate was 100 percent. The clinical diagnosis of seventeen (17) patients in Weno subsequently followed, confirmed by laboratory tests. Over a hundred close contacts received second-line prophylaxis. No fatalities occurred among the treated patients.

According to the CDC, the emergence and transmission of MDR TB in Chuuk's outbreaks were the result of the inability to follow standard TB control practices and to provide appropriate drugs. At the outbreaks' onset, Chuuk lacked an appropriately equipped, ventilated and staffed isolation ward to handle the patients who required immediate hospitalization. The hospital's laboratory could not run the tests required for preliminary diagnosis. Resources to procure the drugs, supplies, equipment and other items needed for treatment were unavailable. Because the public health TB control and prevention program depended only on its share of funding from the FSM's \$230,000 grant award from CDC (for allotment to all states), it was weak, underfunded and understaffed.

In 2008, Chuuk's Department of Health Services redirected a portion of its Compact operating funds to procure its first batch of second-line drugs and to renovate two isolation wards: one for regular TB patients who would otherwise be admitted to the general medical ward and the second designated for MDR TB. JEMCO allocated \$2,637,500 in August 2008 specifically to aid Chuuk's outbreak response. (The special FY 2009 grant remains available until expended.) Multiple other agencies joined the response, including the U.S. Department of Defense, WHO, SPC, and the Commonwealth of the Northern Mariana Islands' Department of Public Health.

## Risks and Vulnerabilities

### ***Dependence on Amended Compact Funding and Other U.S. Federal Assistance***

Compact health sector grants were the primary source of support for the administration and delivery of services through dispensaries, hospitals and primary care clinics, including dental health. Amended Compact financial assistance also supplemented U.S. Federal grant funding for public health programs and management from 2004 to 2008. The provision of local legislative appropriations covering even a portion of annual health sector expenditures was unaffordable to the country's four state governments.

U.S. sector grant funding during the five-year reporting period significantly increased the budgets of FSM state health departments and helped to improve performance. The FSM's sole reliance on this source of limited-term funding, complemented by a handful of congressionally authorized (U.S.) Federal grants, however, is risky.

Operating shortfalls routinely occurred from FY 2004 through FY 2008 that the health departments could not cover. OIA received recurrent requests to reallocate monies among the different expense categories for immediate redress. This redirection of funds was not without repercussions. As an example, it affected the day-to-day management of programs. It also impinged on the resources needed by the health departments to keep adequate supplies and pharmaceuticals on hand.

Long-term dependency on the Compact to support programs and services without other sources of financing affects the sustainability of the local health systems. At the time of this report, budget insufficiencies were common but had not triggered efforts to develop restructuring plans or investigate operating revenue alternatives. The health departments also were not proactive in looking for purchasing and other efficiencies until they faced crises.

Dependence on U.S. Department of Health and Human Services (HHS) grants and cooperative agreements also places the FSM at risk. HHS resources, not local appropriations, have been the mainstay for all public health programs and for the community health centers of Yap and Pohnpei. The Compact grant provides only stopgap help. Smaller amounts of targeted assistance have been available from international agencies such as the World Health Organization, the United Nations Family Planning Agency (UNFPA) and the Secretariat for the Pacific Community (SPC). These agencies do not provide subsidies for day-to-day health program activities.

The table on the following page shows the level of non-Compact health funding received by the FSM in FY 2007, and shared among the four state health departments and the FSM national government.

**FY 2007 Non-Compact Health Sector Funds  
(Source: FSM Office of Compact Management)**

Source	Amount
U.S. Health and Human Services	
Substance Abuse & MH	\$ 611,969.00
Community MH Services Block Grant	\$ 148,674.00
Tobacco Control/Prevention	\$ 205,379.00
HIV/AIDS Prevention	\$ 272,054.00
HIV/AIDS Care II	\$ 50,000.00
HIV/AIDS Surveillance	\$ 17,273.00
STD Program	\$ 66,558.00
Diabetes Prevention/Control	\$ 144,200.00
Preventive Health Services Block Grant	\$ 62,938.00
	\$ 94,644.00
State Systems Development MCH Block Grant	\$ 387,026.00
MCH Block Grant	\$ 146,512.00
Children's Oral Healthcare	\$ 67,159.00
Abstinence Education	\$ 47,492.00
Family Planning	\$ 410,743.00
Immunization	\$ 855,568.00
TB Program	\$ 229,418.00
Public Health Preparedness	\$ 811,415.00
Hospital Preparedness	\$ 703,671.00
Basic Social Services Program	
(ADB Loan)	\$ 8,019,000.00
World Health Organization (consumables)	\$ 500,000.00
<b>TOTAL</b>	<b>\$ 13,851,693.00</b>

The information provided by the FSM includes direct grants and loans only. It excludes an assignment of the dollar value of technical consultation and training assistance. Also excluded is the estimated \$20,000 in drugs the FSM receives annually from the UNFPA and \$60,000 from UNICEF.

From 2004-2008, no national or state revenue found its way back to the state health departments to support recurring operations except in Pohnpei. (In Pohnpei, the legislature provided appropriations of less than \$100,000 to cover the salaries of select staff.) Although the state health departments are the only major providers of public health, primary care and secondary medical services in the FSM, and are the referral points for non-insured patients needing out-of-country medical attention, they commanded little budgetary attention from the legislatures. The National Department of Health and Social Affairs (HSA Division of Health) a recipient of Compact support, fared better in terms of garnering appropriations from the FSM Congress but constitutionally has no role in the provision of direct health care.

### ***Inattention to Planning***

The poor attention given by all five FSM governments to plan in advance for the Amended Compact's annual funding decreases have the potential to cause contractions to health service and program levels when the decreases in sector grant allocations begin in earnest. If the FSM fails to comprehensively consider the consequences of annual funding decreases on health needs and priorities, the result will harm rather than improve health status. The impact will be difficult to reverse.

Each hospital has established special accounts for user fee receipts and fee-for-service payments and capitation or fee-for-service payments from MiCare, the FSM National's health care insurance provider. From 2004 through 2008, the balances were nowhere near the amount needed to offset general operating expenditures. The accounts functioned instead as a small cushion for emergency purchases of drugs or other expenses that fall outside approved health sector grant uses. None of the state health departments undertook a review of its fee schedule to determine if increases would be appropriate. While not a wholesale solution to health care financing, fees charged for outpatient and inpatient services would aid in cost recovery.

Unless the health departments begin receiving a share of supplemental general revenue support from state governments, can capture fees that approach the real cost of providing health care and can begin to aggressively reassess services for spending efficiencies, reliance only on Compact funding and Federal grant support will lead to a diminishing ability to provide health care services.

Inattention is also evident in the sluggish pace of planning to replace the country's aging workforce of doctors, dentists and nurses who retire in five to ten years, to train health workers for primary care and to provide specialty training for both doctors and nurses. Affiliation arrangements with health professional schools outside the country are negligible. Most allied health workers such as dental nurses and assistants, practical nurses, x-ray and laboratory technicians received on-the-job training. If the FSM fails to have individuals in the pipeline for

health professional education in adequate numbers and gives short shrift to upgrading the existing workforce, then the hospitals throughout the country will be dependent on recruiting hard-to-identify and expensive expatriate staff.

### ***Delivery of Health Care in Remote Settings***

Both Yap and Chuuk States employ an extensive and fragile system of dispensaries and outposts to provide basic health care to outlying populations. The location of the facilities depends on population, need, and political considerations. Symptomatic treatment of common ailments is the primary service provided by one or two health assistants who received their initial training from hospital staff before posting. Evacuations occur to the main hospital using small boats, ship transport (when available) and small planes (if available) when patients need advanced medical attention. Communication between the hospital and dispensary for consultation and inventory and data reporting depends on whether working radios are available. Visits by medical teams and public health program staff and for the restocking of medicines and supplies rely on state-operated ships that are often unavailable or out of commission, or by small boats.

Chuuk's system of 86 far-flung dispensaries was particularly problematic in 2004. Ghost employees, poor restocking practices, political appointments, dilapidated and unsafe facilities, unannounced closures because of health assistant absences and moving dispensary operations into private homes were common occurrences. In 2005, at JEMCO's direction, the Department of Health Services, with the national government's assistance, began a systematic assessment that ultimately resulted in the closure of 10 facilities, bringing the number to 66 in 2008. Also instituted was a new five-region system of supervision and retooled inventory and restocking practices.

Private land ownership and title disputes in Chuuk prevented repairing, renovating and reconstructing activities from moving forward. The lack of project movement in public infrastructure sector development and delinquent FSM deposits to the IMF were also factors, not just in Chuuk but also affected health facilities on Yap and Pohnpei. This stalemate meant that many settings used for providing health care remained unsafe and unsanitary. Unless a solution to the infrastructure stalemate comes soon, lives will be at risk and patients who can travel will choose to come to the hospitals for care.

## **The Public Sector Infrastructure Program**

### **Priority of the Amended Compact**

#### ***Sense of Congress***

Public Sector Infrastructure Development is the most visible component of the Amended Compact's financial assistance program and, along with education and health, ranks among its top priorities. PL 108-188, Section 104(g), gives weight to the sector's importance with the

inclusion of the sense of Congress that “not less than 30%” of annual Compact funding should go to infrastructure development.

## Development Progress

### ***Disappointing Start***

Progress by the FSM to put plans in motion for the construction, renovation and repair of public sector infrastructure was slow and disappointing during the five-year reporting period. The nation failed to seize the early opportunity to improve long-neglected education and health physical facilities, and lost the benefits of economic activity and increased employment that would have resulted from an active capital improvements program.

A number of factors hampered the FSM’s performance from FY 2004 through FY 2008. A significant impediment was the lack of a strategically implementable national infrastructure development plan that identified clear priorities for the replacement, renovation or repair of education and health facilities throughout the country. Without this roadmap, the selection of projects became ad-hoc and based on short-term or political need. The FSM resisted prioritizing projects across the nation and preferred to allocate funds among the four states on a formulaic basis.

The FSM also resisted and was slow to institute a process-based approach that would guide:

- Infrastructure project selection based on critical needs;
- The development and adherence to recognized professional construction and safety standards; and
- Project implementation from initial design work to actual construction.

From 2004 through 2008, the FSM also failed to adequately address the issue of obtaining the public use of land for education and health facilities. This factor prevented the implementation of critically needed infrastructure development projects in Chuuk State, where almost every school needs replacing. The FSM’s failure to contribute matching funds to the Infrastructure Maintenance Fund also set back the Compact’s goal of institutionalizing the practice of regular maintenance by the four state governments.

### ***Stalemate Over Issues***

JEMCO allocated approximately \$131 million to the FSM for Public Sector Infrastructure projects from FY 2004-2009.

In 2003, the Office of Insular Affairs provided the FSM with non-Compact technical assistance funds to develop a national infrastructure development plan that would facilitate implementation of capital improvement projects under the Amended Compact. The FSM completed the plan but the FSM Congress and all four state legislative bodies failed to adopt



the document, thereby delaying its transmittal to JEMCO for its concurrence. This delay essentially suspended the initiation of construction projects until some eighteen months after the Amended Compact went into effect.

Infrastructure funds did not begin flowing to the FSM until FY 2006 and then only for two minor projects. Contractual disputes, controversies over land ownership, the nonconformity of project proposals with the priorities of the Amended Compact, the continued application of an ill-fitting internal FSM money distribution formula and misinformation all contributed to the delay.

The FSM's Infrastructure Development Plan (IDP) recognized that the size of the infrastructure investment program was such that its successful and timely execution would require substantial improvement of the FSM's internal capacity to carry out public works projects. The IDP stated that implementation would require a high level of program management, technical skills, financial and reporting skills for detailed planning, technical analysis, resource mobilization and reporting systems. The Plan proposed that the FSM establish a Program Management Unit at the national level that would be responsible for the development of program management systems. The FSM's political leadership adopted the IDP but did not dedicate the financial resources necessary for effective professionally driven project and program management.

A shortcoming of the IDP is that it is overly broad and ambitious. It identified an investment of \$2.3 billion spread across 750 projects from 2003-2017. A National Steering Committee developed a summary that the FSM Congress adopted in mid-2004. JEMCO received this legislatively endorsed summary as the nation's official plan but the document neither contained project-specific scopes of work, detailed cost estimates nor implementation timelines.

The FSM Congress failed to approve the use of Amended Compact grant funds in a timely manner. It applied an internal per-capita formula for the division of funds instead of applying a needs-based approach to the selection of projects. Chuuk State Government's inability to secure legal authority for the public use of land also hindered infrastructure development despite overwhelming development needs.

In 2004, the Project Management Unit (PMU) hired a U.S.-based firm to serve as its project management consultant. The FSM terminated the contract for cause in May 2007, which resulted in a civil lawsuit that is currently before the FSM Supreme Court. The legal dispute further slowed progress in implementing projects.

Because of cost, the state governments were reluctant to accept architectural designs that used high-grade materials to ensure longevity, functionality, and safety. The governments argued that higher costs would mean less funding for other projects proposed by the states. However, OIA, in exercising its grant management responsibility, insisted that project proposals should not compromise quality and safety. The opposition largely subsided at the end of FY 2008 when new leadership across the nation accepted the three basic tenets of infrastructure sector project funding: 1) adherence to professional design and standards, 2) professional management and administration of projects and 3) a primary focus on selecting health and education projects for implementation.

### ***Developments in 2007- 2008***

Measurable progress to move forward with capital projects was not apparent until 2007 -2008, when the FSM national government established a nascent professional technical unit to oversee project development throughout the country. To staff the unit, the PMU hired a qualified professional engineer to act as Contracting Officer's Representative on behalf of the FSM national government to identify and initiate development of projects throughout the FSM. The addition of more professional personnel, however, encountered political opposition due to perceived cost issues. Progress quickly stalled even though Amended Compact funding was available for personnel and other in-house expenses. Consequently, most FSM states still lack the expertise to develop and professionally manage projects.

The PMU awarded approximately \$45 million worth of civil works contracts in FY 2008. This activity suggests that the slow start in public sector infrastructure development may have turned the corner. Approximately twelve projects with a combined estimated value of \$36 million are in design phase by third party professional engineering and design firms contracted by the FSM national government.

The FSM used approximately \$6 million of U.S. Amended Compact infrastructure grant funding as the local 5 percent funding match required for Federal Aviation Authority Airport Improvement Projects that are in process across the four FSM state governments. Eligible projects include improvements related to enhancing airport safety, capacity, security, and environmental concerns.

### **Finding Ways Forward**

The FSM will need to address the immediate need for additional expertise in professional engineering and contract management. Without added qualified personnel, the PMU will find itself buried by its workload. Land issues surrounding health and education facilities in Chuuk at the time of this report are still largely at a standstill and need expeditious resolution. The FSM needed to find solutions to the problem of attracting construction companies willing to work in the region, especially in Chuuk.

## **Private Sector Development**

### **Sector Objectives and Priorities**

The purpose of the Private Sector Development grant (PSD) is to support the FSM's efforts to attract new foreign investment and increase indigenous business activity. The Amended Compact gives priority to advancing the private development of fisheries, tourism and agriculture; employing new telecommunications technologies; and analyzing and developing

new systems, laws, regulations and policies to foster private sector development, to facilitate private investment, and to develop business and entrepreneurial skills.

The Amended Compact does not authorize loans to stimulate private sector activity or provide awards of sector funding to private businesses.

**U.S. Grant Funding and Activities from 2004 through 2008**

***Grant Award Totals***

From 2004 through 2008, FSM received a total of \$16,650,133 in grant assistance for private sector development. The following table shows the breakdown of the grant awards by year and government.

	National	Chuuk	Kosrae	Pohnpei	Yap	Totals
2004	\$ 513,091	1,338,874	795,261	525,423	613,470	\$3,786,119
2005	\$ -0-	1,403,876	988,025	657,602	989,407	\$ 4,038,910
2006	\$ -0-	1,498,616	606,029	887,817	1,046,701	\$ 4,039,163
2007	\$ 25,000	831,359	414,199	499,854	509,184	\$2,279,596
2008	\$ 50,000	914,373	567,101	143,754	\$ 832,217	\$2,506,345

***Initial Difficulty Adapting to New Use***

The FSM initially had difficulty adapting its activities and budgets to meet the spirit and intent of the Amended Compact. Because the PSD grant does not underwrite general government operations, certain agencies and offices were no longer eligible for funding. This disqualification caused serious financial problems for the FSM states since none had sufficient government revenue to cover the budgets of numerous offices and agencies that received support under the original Compact.

The FSM proposed ad hoc uses of grant assistance for governmental offices with functions related to private sector development. JEMCO allocated U.S. funding if there were reasonable performance measures in place and if the Committee could anticipate beneficial outcomes. Over the five-year period, support continued only for those programs that showed measurable performance. Funding ceased to non-performing programs and offices.

JEMCO's allocation decisions took into account the policy framework of the Amended Compact. Pohnpei State, for example, enacted a foreign investment law that was restrictive to foreign investment. At its August 2008 meeting, JEMCO determined that the policy ran counter to the

Amended Compact's overall goals for economic growth and consequently withheld funding for Pohnpei's PSD projects for FY 2009.

### ***Successful Grant-Supported Activities***

From 2004 through 2008, PSD grant funding mainly supported government projects related to private sector development. None of the FSM states or the national government requested specific grant assistance to reform the regulatory environment, to ensure the fair and equitable application of laws regarding foreign investment, or to develop policies to foster private sector investments.

The following is a description of examples of grant-supported activities that met with success in the majority of FSM states.

#### Visitor Bureaus

The efforts of FSM state bureaus resulted in increased visitor traffic that had a direct impact on the FSM economy. Activities included:

- Publishing brochures and other promotional material;
- Participating in trade shows in Japan, the U.S. and elsewhere;
- Maintaining websites to attract and provide information to potential visitors;
- Organizing community outreach cleanups;
- Collecting and analyzing terrorism data; and
- Facilitating the development of local products for sale such as woven fans and coconut oil and soaps.

#### Small Business Development

The Small Business Development Centers (SBDC) in Chuuk, Yap, and Kosrae provided incubation services to start-up businesses. Their activities included:

- Providing free or low-cost retail space;
- Providing training in day-to-day business practices; and
- Helping prospective and current businesses develop medium-term business plans.

#### Exports

The FSM had some success in exporting local products such as kava and betel nut between states, and exporting products abroad such as trochus and sea cucumber. These activities produced substantial, albeit sporadic, income for local businesses and for joint ventures with Asian partners. One of the most successful export activities was the state-supported operation of a high quality bottled water plant in Kosrae. Kosrae also attempted to export mangrove crabs but the project failed because of the lack of expertise to manage and market the program.

### Import Substitution

PSD grant-funded projects included the training of people engaged in subsistence agriculture and fisheries. Funding support also went to the operation of a plant propagation laboratory to develop new strains of edible plants in Kosrae and to provide growth stock to the other FSM states. The Yap Department of Agriculture is in the process of turning much of its operations over to the Yap Farmers Cooperative. The Chuuk SBDC sponsored a daily farmers/small business market. Quantifiable measurement of the impact of these FSM import substitution efforts was not possible during the five-year reporting period.

### Land Management

Land registration is a significant issue throughout the FSM. The PSD grant supported the operation of land management offices in all four FSM states for two reasons: (1) the promotion of private sector business development depends on legally surveyed and registered land to avoid ownership disputes, and (2) the process of verifying public land leases provides an enabling framework for public infrastructure projects.

### Barriers to Private Sector Development

#### ***Lack of Planning, Policies and Coordination***

During the five-year reporting period, the FSM lacked an overall comprehensive strategy to achieve sector-wide goals or even to meet the project-based objectives advanced by each state. The effective use of United States PSD grant funding would benefit from the development of a national plan to guide private sector development nationwide or a management process that, at a minimum, will provide project plans and a timetable for achievement over a medium term of three-to-five years. This planning effort should include identifying relevant organizations, facilities, personnel, and expertise, and describing the policy environment needed to sustain and grow the private sector.

Kosrae state established an Export Council to coordinate the production, marketing and transportation of its exports. The establishment of a similar entity at the FSM national government would be appropriate to coordinate export activities in all of the four states.

National policies governing private sector development, whether enacted by law or established through Executive Branch regulations and the availability of policy guidance to the states are especially critical areas that need attention. Reforms in land, taxation, the FSM foreign investment climate, and judicial policies would contribute to private sector growth.

## The Environment Sector

### Purpose of the Grant

The Amended Compact provides a broad definition of the allowable uses of the Environment Sector Grant to protect the nation's land and marine environment and to conserve and achieve the sustainable use of its natural resources. Financial assistance may support FSM's efforts to:

- Develop, adopt, and enforce applicable policies, laws and regulations;
- Reduce and prevent environmental degradation and all forms of environmental pollution;
- Adapt to climate change;
- Protect biological diversity, including the assurance of adequate legal and international treaty safeguards relating to the protection of botanical and other agro-ecological property belonging to the FSM;
- Establish and manage conservation (sustainable use) areas;
- Develop environmental infrastructure plans;
- Design construction relating to the environmental sector;
- Operate, interact and cooperate with non-governmental organizations;
- Promote increased environmental awareness in governmental and private sectors; and
- Promote the increased involvement of FSM citizens and traditional leaders in conserving their country's natural resources.

The Amended Compact did not outline the use of the Environment Sector Grant to provide for environmental protection to create public health-supporting conditions, improve solid waste management practices, or provide for mitigation after chemical or other biohazard exposure, nor were sufficient allocations of funding assumed for those uses. At the time the Amended Compact was negotiated, FSM health departments were responsible for environmental health. Since implementation of the new agreement only Kosrae's Department of Health Services maintained potable water testing as a function and only Chuuk's Department of Health Services retained a sanitation program. Most environmental health functions transferred to state environmental protection agencies outside the administrative control of the health departments.

## Funding History and Grant Uses

From FY 2004 through FY 2008, the FSM received a total of \$10,567,452 in grants for the environment. The table below shows the grant awards by year and recipient entity.

	National	Chuuk	Kosrae	Pohnpei	Yap	Total
2005	\$ 111,421	502,499	296,592	688,181	791,258	\$2,389,951
2006	\$ -0-	798,428	335,240	665,807	337,977	\$2,137,452
2007	\$ 25,000	747,259	149,277	630,544	574,834	\$2,126,914
2008	\$ 50,000	717,042	220,165	481,576	421,160	\$1,889,943
2004	\$ 79,477	378,394	302,523	666,944	595,854	\$2,023,192

Annual grants from FY 2004 through FY 2008 funded the operations of the state environmental protection agencies or equivalent offices. Much of the work focused on issuing permits for landfills and other earthmoving projects because the offices lacked the authority, expertise and facilities to control many of the environmental protection areas that fell under their purview. The offices also organized the improvement of solid waste management and facilities in Yap and Kosrae, and there are plans for similar work in Chuuk and Pohnpei. The U.S. Environmental Protection Agency (EPA) certified all four state agencies for water testing quality.

Non-EPA activities that received U.S. Environmental Sector Grant funding included:

- Operations of solid waste facilities in Pohnpei, Kosrae and Yap;
- Historic preservation efforts in Pohnpei and Yap to restore and preserve villages and other structures for practical as well as tourism purposes;
- Projects to restore or increase agricultural, forest and marine resources;
- Monitoring of coral reefs; and
- Publication of biological and climate change studies

## Issues Affecting Effective Grant Planning and Implementation

### ***Overly Broad Management Focus***

The FSM faces unresolved issues regarding the conservation of its natural resources, but it also must simultaneously deal with the effective management of potable drinking water, wastewater and solid waste disposal, and the recycling of metals and plastics. There were attempts during the five-year reporting period to address these concerns but results were

variable, with some of the states able to accomplish more than others. Non-governmental organizations such as the Micronesian Conservation Trust and the Nature Conservancy have taken the lead on resource conservation matters, enabling Amended Compact grant funds to be used for environmental management and protection.

### ***Planning***

During 2004 through 2008, the FSM submitted grant budgets for review that lacked linkages back to the nation's Strategic Development Plan or any other comprehensive nationwide plan relating to the environmental sector. As such, proposed activities by the four states were ad hoc. Noting the lack of a planning framework, the U.S. EPA (Region IX) helped the four FSM states develop a draft environmental protection plan in 2008.

JEMCO has twice allotted funds to the national government to create a plan for the environment sector. In FY 2007, the annual sector grant to the FSM included \$25,000 for the planning activity and in FY 2008, \$50,000.

In 2007, the FSM national government established the Office of Environment and Emergency Management. The office has yet to establish lead role in coordinating environment sector activities in the states as the authorities of the office are not clear.



## Public Sector Capacity Building

### Purposes of the Sector Grant

The Public Sector Capacity Building Grant (PSCB) supports the FSM's efforts to build effective, accountable, and transparent national and local government and other public sector institutions and systems. The Amended Compact gives priority to activities improving economic planning, financial management, auditing, law enforcement, immigration controls, the judiciary, and the compilation and analysis of appropriate statistical indicators. The goal of Amended Compact financial assistance is to ensure the carrying out of essential functions and to ensure that qualified personnel fill those essential positions.

### Grant Funding History and Uses from 2004 through 2008

#### ***Funding History***

The FSM received a total of \$38,652,068 in annual grants to build public sector capacity from FY 2004 through FY 2008. The table below shows the grant award history by year and by recipient government.

	National	Chuuk	Kosrae	Pohnpei	Yap	Totals
2004	\$4,287,697	2,853,813	1,013,866	1,676,163	1,831,307	\$11,662,846
2005	\$ 608,028	3,001,410	1,113,866	1,542,488	1,520,446	\$ 7,786,238
2006	\$ -0-	2,724,099	1,346,976	759,254	1,345,585	\$ 6,175,914
2007	\$ 473,238	2,950,592	1,231,867	729,991	435,957	\$ 5,821,648
2008	\$3,305,686	1,034,122	1,534,009	709,883	621,722	\$ 7,205,422

#### ***FSM-Wide Projected Budgetary Crises Prompts Transitional Grant Use***

Financial circumstances in the FSM made immediate implementation of the PSCB grant difficult without a transition period. The four FSM states entered FY 2004 with severe projected budgetary shortfalls that made it impossible to cover the general operations of offices funded under the original Compact without immediately undertaking massive unplanned budget cuts and reductions in force. The FSM asked for a period of transition to fund those operations with Amended Compact funds while the states undertook steps to increase their locally funded revenue base. JEMCO agreed to a period "not to exceed five years" for the migration of non-conforming expenses and "in amounts no less than 20 percent of the totals in each year, unless otherwise mutually agreed." The Committee also stipulated that the FSM submit a written plan within six months of the issuance of the grant award, for the orderly migration of basic operations funding to general revenue or other sources. The transition period ended after FY 2008.

For the FY 2004 grant year, PSCB supported those services identified as critical to FSM operations during the transition. Finance and budget offices, administrative services (including planning), and the judiciary branch received U.S. funding for all four states. The grant also covered: (1) the FSM national government's Department of Economic Affairs; (2) the Department of Public Safety, Micronesian Legal Services, and the Attorney General's Office in Chuuk; (3) the Attorney General's Office in Kosrae; (4) health training in Pohnpei; and (5) the Departments of Public Safety (law enforcement) and Resources and Development in Yap. JEMCO applied a special grant condition to allocated U.S. funding for public auditor offices as "capacity building at its essence" since their functions include the identification of deficiencies in fiscal procedures and performance.

### ***Focus on Improved Financial Accountability***

JEMCO approved the use of \$500,000 in PSCB funding for the Chuuk Financial Control Commission (CFCC), an oversight body created by the FSM national government and the United States. Enacted by law in Chuuk State, the purpose of the CFCC is to improve financial management and accountability controls over Amended Compact funding transactions. U.S. grant funding of the CFCC began in FY 2005 and continued through FY 2008. For FY 2007, JEMCO also allocated U.S. funding for the FSM Office of the Public Auditor to undertake additional oversight and audit activities related to the Compact sector grant allocations received by Chuuk.

From FY 2005 through FY 2008, PSCB funding supported the placement of budget and finance advisors in the FSM states to provide training and technical assistance in accounting practices, audit preparation and resolution of findings, and financial reporting. The attention given to improving financial and audit functions throughout the FSM had substantial results, including clean audit opinions received by Pohnpei, Yap and Kosrae without questioned costs. Improvements to Chuuk's financial management activities were slow to take root but better financial transactions and reporting were evident by the close of FY 2008.

PSCB also funded planning, technical assistance, external evaluation and installation support for the FSM's new nationwide financial management information system from FY 2007 through FY 2008. An OIA technical assistance grant funded the initial work on the project prior to FY 2007 and combined resources from the Amended Compact and OIA sustained the project's momentum through FY 2008. The new system corrects the accounting and financial reporting problems that stemmed from the existence of three different accounting systems and the resulting lack of uniformity among FSM's five government entities.

### ***Improved Performance Management***

For FY 2008, the FSM Office of Compact Management received \$350,000 in PSCB assistance to provide the states with technical help to improve performance measurement and reporting. A part of OCM's capacity building initiative included preliminary work to develop education and health indicators and to advance a uniform computerized reporting system for the nation. (The effort did not produce the quality of reports required under the Amended Compact and did not influence performance planning by the departments of education and health services.)

### ***General Fund Crises and Reduction in Force in Kosrae and Chuuk***

In 2007 and 2008, the Governments of Kosrae and Chuuk faced general fund budgetary problems of such magnitude that immediate redress was necessary to prevent the governments' insolvency. Kosrae, for example, had almost no money left to cover state-funded government operations in the 3<sup>rd</sup> and 4<sup>th</sup> quarters of FY 2007 and faced a projected budgetary shortfall of approximately \$2 million in FY 2008. Chuuk had outstanding debt obligations of around \$46 million.

PSCB grant assistance provided the states with the means to reduce their general fund burden by reducing the number of state-funded public service employees. (The grant, in part, funded RIF or reduction in force payments). Kosrae eliminated 98 positions by October 1, 2007 and reduced the salaries of its remaining employees by 5 percent while taking action to increase the State's sales tax and adopting other revenue enhancing measures. Chuuk eliminated 317 state-funded employees while also undertaking a series of steps to adopt other austerity measures. The states' efforts were successful in averting financial calamity. Kosrae ended FY 2008 with a budget surplus of almost \$300,000. Chuuk also had a budget surplus in 2009 and was able to satisfy many of its outstanding vendor payments.

### **Need to Focus Attention on Capacity Building**

#### ***Planning for PSCB***

There are many needs in the FSM where PSCB grant assistance could aid in achieving more efficient and effective management, operations and results. Public utility entities across the country are in a state of crisis. Public safety and legal systems continue to need support. Economic and statistical analysis capacities are in short supply. The FSM still needs a guiding framework for identifying its priorities for public sector capacity building and understanding how it should grow that capacity while minimizing dependence on outside consultants. The FSM also needs to reach consensus on what outcomes are desirable and sustainable for building its public sector and agreement on an achievable timeline.

#### ***Continuing Need***

Financial accountability benefited from U.S. PSCB grant funding during the five-year reporting period but the needs for the building of sustainable capacity are far-reaching. Future assistance is necessary to ensure that the improvements gained from FY 2004 through FY 2008 will continue over time and become part of the institutional fabric of state budget and finance offices. Continuing support to the CFCC is essential until JEMCO has confidence that Chuuk State has built adequate safeguards in its existing accounting system and daily practices to ensure the appropriate use of Amended Compact funds. Attention needs to be directed to developing the capacity of the FSM national government to meet the reporting requirements of the Amended Compact. Often the states are not to blame for late and incomplete reports, but reporting deficits result from an overburdened and undertrained FSM national staff.

## **The Disaster Assistance Emergency Fund Sector (DAEF)**

In 2003, the U.S. Congress passed legislation to amend Article X of the Compact that stipulated the responsibility for disaster response and reconstruction in the FSM would transfer from FEMA to the U.S. Agency for International Development (USAID) as of November 4, 2008. The resulting agreement took effect in FY 2009.

The amendment defined the process for requesting USG disaster assistance including the establishment of a Disaster Assistance Emergency Fund (DAEF). It states that in order to request USG disaster assistance, the FSM must:

- Have an FSM Presidential Disaster Declaration as described in law;
- Determine that the disaster is beyond ability of the FSM Government to respond to even with DAEF;
- Request the assistance of the United Nations;
- Request up to \$50,000 available from the U.S. Ambassador's Fund;
- Conduct a joint preliminary disaster assessment (PDA) within 10 days of the disaster with FEMA and USAID;
- Have a declaration of disaster by the US President to make the disaster relief fund available; and
- Develop a reconstruction plan within 60 days of the event.

Under the guidance of the U.S. Chief of Mission (U.S. Ambassador to the FSM), USAID will coordinate its activities with U.S. Embassy staff to promote the sharing of relevant information and to assist and facilitate the performance of responsibilities as described in the Amended Compact. The amendment and a subsequently executed memorandum of understanding also calls for USAID to work in close collaboration with the FSM national authorities, outer-island local elected officials and community leaders.

The Amended Compact calls for the U.S. and the FSM to each deposit \$200,000 annually adjusted for inflation into the DAEF account.

## **Single Audit Assistance**

Section 213 of the Amended Compact authorizes annual grants to the FSM to conduct the audit required by the FPA. The funding does not include inflation adjustment. From FY 2004 through FY 2008, the FSM received \$500,000 each year for that purpose. The FSM has shown significant improvements in audit findings since the implementation of the amended Compact.

## **Judicial Training**

Under the Amended Compact, the FSM annually receives U.S. funding for the training of Micronesian judges and officials of the judiciary. The Pacific Islands Committee of the Ninth

Circuit Judicial Council coordinated the activities during the five-year reporting period. Under the leadership of FSM High Court Chief Justice Andon Amaraich, the FSM Judiciary developed a scope of work for the annual use of the money.

**EXTENDED FEDERAL PROGRAMS, SERVICES AND TECHNICAL ASSISTANCE**

Federal services and related programs extended to the FSM under the Amended Compact include those of the U.S. Weather Service, the U.S. Postal Service, the U.S. Federal Aviation Administration (FAA), the U.S. Department of Transportation, the U.S. Department of Homeland Security, and the U.S. Agency for International Development through its Office of Foreign Disaster Assistance. The chart below shows the FSM's expenditures of Federal awards

by granting agency. (The amounts do not distinguish if the funds went to the FSM national government, the states or a combination of the two.)

**Summary Schedule of Expenditures of Direct Federal Awards by Grantor**  
**Source: FSM Single Audits**

U.S. Agency	FY End 2004	FY End 2005	FY End 2006	FY End 2007	FY End 2008
<b>Agriculture</b>					
<i>Forestry</i>	\$ 262,515	\$ 281,289	\$ 553,096	\$ 201,830	\$ 241,540
<b>Commerce</b>					
<i>NOAA</i>	\$ 877,792	\$ 1,148,857	\$ 908,602	\$ 1,096,129	\$ 1,218,474
<b>Interior</b>					
<i>Compact and Technical Assist</i>	\$ 62,079,493	\$ 53,736,100	\$ 66,072,608	\$ 68,978,743	\$ 63,981,551
<b>Labor</b>					
<i>WIA</i>	\$ 2,536,135	\$ 2,909,248	\$ 3,985,416	\$ 517,558	\$ 418,013
<b>DOT</b>					
<i>FAA/AIP</i>	\$ -	\$ 1,363,125	\$ 2,222,743	\$ 6,392,626	\$ 10,508,579
<b>DHS</b>					
<i>Disaster/Hazard Mitigation</i>	\$ 3,579,999	\$ 4,576,145	\$ 3,636,137	\$ 4,306,572	\$ 4,420,188
<b>Education</b>					
<i>Special Education TQE/SIP</i>	\$ 4,912,797	\$ 8,148,462	\$ 5,358,252	\$ 4,662,293	\$ 4,572,881
<b>HHS</b>					
<i>Various</i>	\$ 3,907,209	\$ 5,049,275	\$ 4,334,071	\$ 4,545,888	\$ 5,050,132
<b>Museum and Library Services</b>					
<i>Library Services</i>	\$ -	\$ -	\$ 5,969	\$ -	\$ 6,621
<b>Total</b>	\$ 78,155,940	\$ 77,212,501	\$ 87,076,894	\$ 90,701,639	\$ 90,417,979

A description of the services and programs provided by the Federal Aviation Administration from 2004 through 2008 follows as an example of the kinds of the assistance available to the FSM.

## FAA Airport Improvement Program (AIP) Grants

- FAA Micronesia AIP Grant Authorization

The Federal Aviation Administration (FAA) Reauthorization Act of 2004, made the Government of the Federated States of Micronesia eligible for U.S. Airport Improvement Program (AIP) funding from the discretionary fund and the Small Airport Fund from FY 2004 through FY 2007. The FAA has been assisting the FSM government in developing its Airport Capital Improvement Program and providing AIP grant funds for needed airport projects.

- AIP Grants to FSM

The FSM received almost \$50 million in AIP grants from FY 2004 to FY 2009 for airport improvements. The projects included needed airfield pavement rehabilitation on the runway, taxiway and apron. AIP grants also purchased two new Aircraft Rescue and Firefighting (ARFF) vehicles to meet FAA and ICAO certification safety requirements, and included construction of a new ARFF building to house and maintain the vehicles. The United States, through AIP, also is funding an airport master plan that is currently being prepared. The airport master plan will review the existing and future requirements of the airport system in the FSM.

## FAA Technical Assistance

- Pacific Aviation Directors Workshop

The Pacific Aviation Directors Workshop is an annual workshop conducted by the FAA to ensure effective communication between FAA, FSM government officials, all FSM airports, FAA lines of business, other US Government agencies, and air carriers.

- Airport Improvement Program Workshop

The design of this annual workshop specifically meets the needs of the six Micronesia airports receiving Airport Improvement Program funds. The workshop also covers FAA Regulatory Airport Standards, airport inspections, maintenance, and operations.

The AIP workshop provides technical training and assistance to Micronesian Airport managers and brings together resources, as well as training, from other US Government agencies to improve airport operations in these countries.

- Micronesia Customer Focus Forum

This forum convenes monthly. Although it usually meets via telecom, it also occurs in person concurrently with other workshops. FAA hosts and facilitates the Customer Focus Forum. Airport Managers of the three FAS countries attend the Forum, as well as several FAA lines of business, the National Weather Service, and the airlines. This forum

helps with communicating procedures and addressing current and critical issues in a timely manner.

- **Aircraft Rescue and Fire Fighting Training (ARFF) and Emergency Readiness**

FAA manages various interagency agreements that provide for basic, intermediate, advanced, and recurring airport rescue and firefighting (ARFF) training, surveys, and assessments, as well as onsite emergency readiness exercises. The FAA holds ARFF training year round at the Pacific Region ARFF Training Center in Saipan. Professional firefighting personnel assess and train the countries in order to raise the ARFF readiness capabilities. The FAA conducts emergency airport operations readiness training and exercises every year at two Micronesian airports.

- **Supplementary Aviation Weather Reporting Station (SAWRS)**

The newly constructed ARFF buildings house the SAWRS stations. With construction of the ARFF buildings, FAA seized the opportunity to upgrade the SAWRS stations. These stations provide critical information to pilots, such as current weather and other advisory services. Once completed, the SAWRS will be equipped with all new working, reliable, and efficient office and weather equipment funded through the FAA Micronesia Technical Assistance Program. The new Kosrae SAWRS facility is operational.

- **Technical and Managerial Training**

The FAA has been working with FSM to identify technical, managerial, and executive training needs and to provide the necessary funding and arrange for training of Airport Management. Over a dozen FSM officials have received training at the FAA Technical Academy in Oklahoma and at the FAA Center for Management and Executive Leadership in Florida.

## **CONCLUSIONS AND RECOMMENDATIONS**

The first five years of implementing the Compact's new provisions and delivery system for financial assistance was a time of learning and adjustment for both the United States and the Federated States of Micronesia. Accountability provisions of the Amended Compact required that both governments remodel policies and prior approaches to planning, budgeting and performance management in order to adapt to the new framework. Implementation of governmental reforms necessary to help the FSM achieve greater economic advancement, and therefore greater budgetary self-reliance, has been complicated and has not moved forward with urgency.



The FSM's early efforts to embrace the obligations and responsibilities of the Amended Compact were constrained by capacity and governance issues as well as political push back to the terms agreed upon under the Amended Compact. As with the start of any new initiative, there remains considerable work ahead. Although education and health are the priorities for United States grant funding, programs within the sectors have not been adequately evaluated or prioritized to ensure Compact dollars are used as effectively and efficiently as possible. Given the country's small size, geographic isolation and limited resources, FSM's economic recovery after the recent worldwide recession will require concerted attention in the years ahead to achieve the goal of longer-term budgetary stability. The impact of decreases in annual Amended Compact grant assistance will require especially careful management to secure the uninterrupted provision of essential health and education programs and services to the Micronesian people.

The Amended Compact memorializes the enduring relationship between the U.S. and the FSM. In addition, to the sector-specific recommendations offered in the body of the report, the recommendations below focus on using that partnership, primarily through JEMCO, to improve the climate for financial stability and performance results in the years looking ahead to 2024, and to increase the effectiveness and efficiency of U.S. funding and technical assistance.

#### **Recommendations:**

1. JEMCO should aid the FSM in planning for the annual decreases in grant assistance, especially with regard to the priority sectors of education, health, and public sector infrastructure development.
2. The FSM and United States should actively seek third-party donors and collaborate in examining the projected income from the Trust Fund for the People of the Federated States of Micronesia after 2023, and explore options that may assist the Fund to increase its projected value within the bounds of acceptable risk.
3. JEMCO should adopt allocation policies and grant conditions that ensure maximum benefit in the sectors of education, health, infrastructure maintenance, environment, private sector development and public sector capacity building.
4. JEMCO and the FSM national and state governments should ensure that annual sector grant allocations follow a well-defined annual budget plan developed by the FSM that has specific annual performance targets that link to the country's Strategic Development Plan and in the case of infrastructure development, to the country's Infrastructure Development Plan.
5. JEMCO should bring substantial and sustained pressure for FSM action on critical economic and financial issues and reform strategies necessary to promote private sector development, including: (1) an equitable and efficient tax system; (2) a reduction of public wage and subsidy expenditures; (3) privatization and/or reform of state-owned enterprises; (4) modernization of the land tenure and titling systems; (5) liberalization of foreign investment laws; (6) improvement in data collection and planning capacities; and (7) establishment of a program for regular maintenance of public infrastructure.

One avenue for this exchange is to extend the annual JEMCO meetings, depending on the agenda, to allow representatives from the U.S. and FSM time to thoroughly review the year's economic and financial developments, and discuss future remedial steps. A mid-year JEMCO meeting convened for policy consultations that pinpoint strengths and weaknesses, and develop mutual strategies for future improvement might be useful.

6. JEMCO should find ways, within its capacity to manage allocations and allocation policies, to encourage the FSM's implementation of comprehensive sector-wide public enterprise reform efforts, including privatization of government owned enterprises and the elimination of inefficient governmental subsidies.

7. JEMCO should require an updated comprehensive infrastructure development plan for health and education facilities that specifically incorporates a baseline investment by the FSM for maintenance.

8. JEMCO should take steps to ensure that FSM's basic education sector grant and SEG assistance primarily support the improvement of the country's basic education system and focus on direct classroom instruction, and that unrealistic expectations for assistance beyond the provision of basic education are curbed.

9. The FSM should request, and the JEMCO should allocate, more public sector capacity building assistance so that there is, for example, sufficient in-country expertise to generate economic and other data and statistical reports. In the case of capacity building in education and health, JEMCO should ensure that sufficient annual grant funding is earmarked to improve data, planning, and policy analysis competencies.

10. The United States should continue provide technical assistance when the FSM articulates critical needs that cannot be addressed through the annual grant assistance process.