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ECONOMIC BRIEF

FSM FY 2021

Graduate School USA

EconMAP
ECONOMIC MONITORING & ANALYSIS PROGRAM

The FY21 FSM Economic Brief

The FSM took strong proactive measures (including border closure) to protect the health of the nation from COVID-19. In the early months of 2020, the onset of the COVID-19 global pandemic ravaged the global economy with an unprecedented reduction in Gross Domestic Product (GDP) and a rapidly rising rate of unemployment. To reduce the spread of the virus, global travel restrictions were implemented, which led to a collapse of international travel. In response to the onset of the pandemic the FSM acted quickly by closing its borders at the beginning of March 2020. While just a single case of COVID-19 was reported in Pohnpei, that individual was identified at the border (port) and remained in quarantine until testing negative for the virus; as a result of these restrictions, the entire FSM has successfully avoided any cases of community spread of COVID-19.

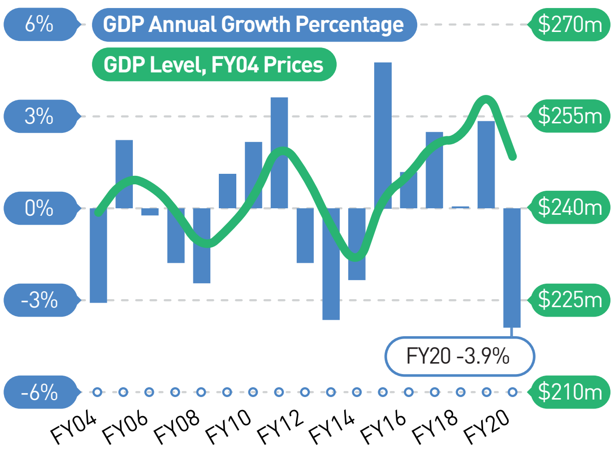
1. The Economy

Performance

Economic performance has been weak and displayed significant volatility during the amended Compact period. The average trend GDP growth during the amended Compact has been weak, averaging 0.3 percent, with GDP only 5 percent higher than in FY2003, see **Figure 1**. Growth has also been highly volatile with great fluctuations. At the start of the amended Compact the economy was forced to adapt to the reality of fewer Compact sector grants and fell to a new baseline. This was followed by a period of rapid construction growth reflecting FAA airport-improvement projects and greater use of the infrastructure grant. When the FAA projects ended and the use of the infrastructure grant was placed

Figure 1: FSM has experienced volatile GDP growth during amended Compact period

GDP level and growth, constant prices 2004



> The FSM took strong proactive measures to protect the health of the nation... and the entire FSM has avoided any cases of community spread of COVID-19.

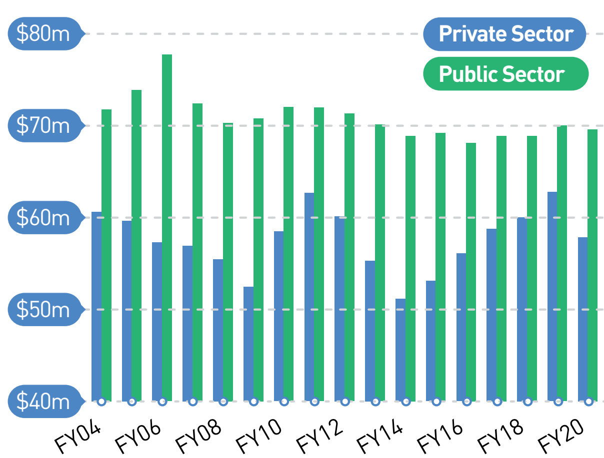
on hold due to management issues, the economy declined again. Matters began to improve after FY2014 as the economy averaged 2.2 percent annual growth through FY2019. The better performance reflected the rapid growth in sovereign rents: fishing fee income and revenue growth from the FSM domicile for large Japanese corporations. The better performance was reflected in growth in two areas: (i) finance and business services and (ii) greater public spending and its impact on the domestic economy, especially in services such as retail and wholesale businesses. By FY2019 the FSM economy looked to be in a good place and on the rise.

FSM economy is projected to contract by 5 percent as a result of COVID-19. In FY2020 the effects of the COVID-19 pandemic hit the economy as the closure of the FSM's borders brought many segments of the economy to an abrupt halt. The worst impacts were felt by sectors related to tourism, which largely came to a close, and transport services (including support to the fisheries sector). GDP is estimated to have contracted by 3.9 percent in FY2020, the worst single-year decline since FY2011, but not unlike other shocks to the FSM economy during the amended Compact. The contraction in FY2020 was only reflected in the second half of the fiscal period (after the initial impact of COVID-19). The GSUSA *Economic Assessment* is projecting a further drop of 1.1 percent in GDP growth for FY2021, indicating the full impact of COVID-19 was a 5 percent decline of GDP.

The private sector was hardest hit by COVID-19 but the impact was strongly mitigated by the various FSM and donor support programs. The projected impact on the FSM economy of COVID-19 is frequently questioned as being, perhaps, an underestimation. The projection, however, reflects the underlying structure of the economy and the relative sizes of the private and public sectors. The COVID-19 impact was almost entirely focused on the private sector, which contracted by 12 percent during FY2019-FY2021, see **Figure 2**. Conversely the public sector went largely unscathed, and provision of public services was not greatly affected. Given the relatively small size of the private sector (22 percent) relative to the total economy, the combined impact on GDP over the two-year period was not as great as may have been anticipated. A second consideration is the significant impact of the various mitigation programs on the economy. The FSM's own economic stimulus program, US health and CARES unemployment benefits, and the ADB COVID-19 Pandemic Relief Option (CPRO), all significantly reduced the impact on the economy. Without these programs it is estimated that the economy would have contracted by 6.9 percent; that is, the mitigation efforts reduced the contraction by 1.9 percent.

Figure 2: Private sector bears the brunt of the COVID-19 impact

GDP Private and Public Sectors, constant prices 2004



Employment

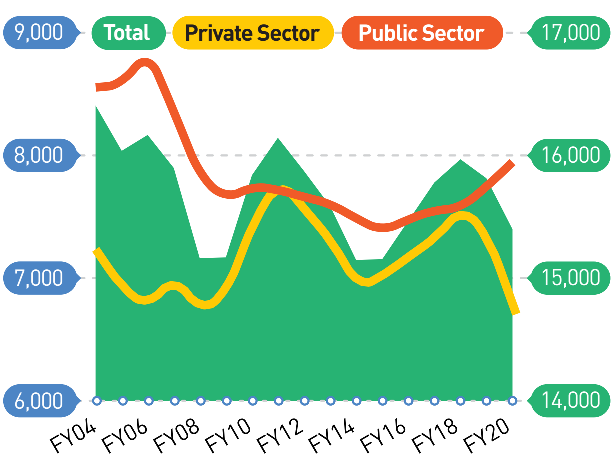
FSM undergoes a painful downward adjustment in public sector employment at the start of the amended Compact: At the start of the amended Compact, public sector employment fell by 1,100 jobs, or 13 percent of the total labor force, from FY2003-FY2008, as the nation made the painful adjustment to the less favorable terms of the amended Compact, see **Figure 3**. From this time the size of the public sector continued to fall but by less dramatic amounts. During the period after FY2015 the public sector has grown by 7 percent and added more than 500 jobs, which reflects the large growth in sovereign rents and fiscal space.

Private sector employment has a highly volatile pattern. After a relatively stable pattern at the start of the amended Compact the private sector grew rapidly from FY2008-FY2011 with over 1,000 additional jobs due to construction activity related to large FAA airport improvement projects and enhanced use of the infrastructure grant. The FAA projects were completed; with contentious issues in the use of the infrastructure grant, construction activity came to a grinding halt and remains so even though some progress had been apparent just before the onset of the COVID-19 pandemic. However, since FY2014 private sector employment started a rebound reflecting both increased demand from fisheries-related activities and booming sovereign rents. In FY2020, the onset of the pandemic resulted in a large reduction in the tourism and transport sectors with a loss of 600 jobs, that is, 8 percent of the private sector labor force.

> The current projection of a 5.0 percent decline in GDP over the period from FY2020-2021 indicates a reduced level of impact from prior projections … arising from the effective impact of FSM managed mitigation and stimulus programs.

Total employment has followed an almost perfect cyclical wave during the amended Compact. The resulting interaction between private and public sectors has been entirely out of phase increasing the amplitude of each cycle creating an almost perfect wave, with only a very modest upward secular trend.

Figure 3: Large decline in public sector employment
Employment by sector



Inflation

Inflation was moderated in FY2020 to 1.1 percent but is expected to accelerate in FY2021. Inflation continued to be modest during the pandemic and fell from the FY2019 level of 2.1 percent to 1.1 percent in FY2020, see **Figure 4**. The rate of inflation in fuel prices fell from 4.8 percent to -1.6 percent in FY2020, which reflects lower international fuel prices during the initial periods of the pandemic. Inflation in food prices also turned negative falling by -0.6 percent in FY2020. In general, prices of imported goods fell during FY2020 while domestic prices rose, although a significant reduction in restaurant prices was recorded due to the impact of the pandemic on

Figure 4: Inflation turned negative in FY2015 and FY2016, and grew modestly in FY2017 and FY2018

FSM CPI, % annual change

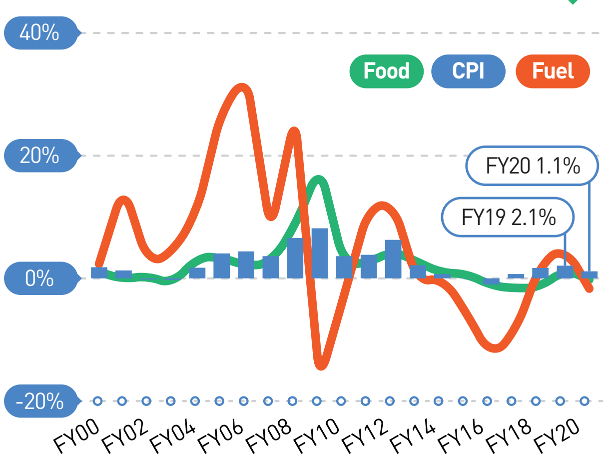
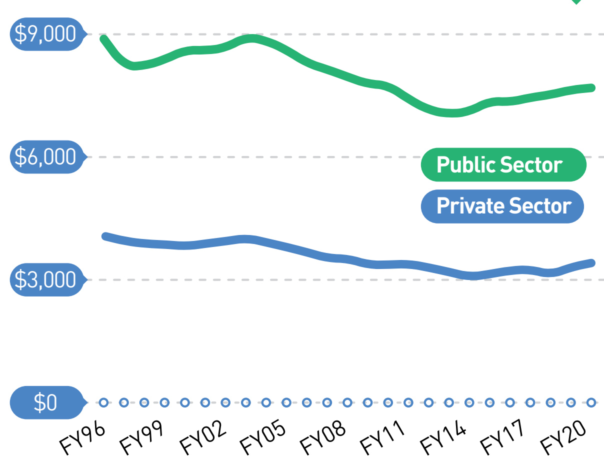


Figure 5: Real Wages decline: public/private sector wage differential remains large

FSM Real wages, FY04 prices



business. In FY2021 it is expected that prices will rise due to rising fuel prices, reported supply shortages of imported goods, and high demand for products; this reflects the impact of various mitigation programs on demand.

Wages

Real wages have fallen in the FSM, but private sector wage growth was above average in FY2020. Wages have grown modestly in the FSM since the start of the amended Compact (rising by 1.9 and 2.0 percent per annum in the private and public sectors, respectively, see **Figure 5**. However, once inflation is accounted for, real wages have fallen in both sectors by 1.0 and 0.9 percent, respectively, which is indicative of declining standards of living. During the more recent period from FY2014 these trends appear to have been in reverse with real wages in both sectors recovering some of the earlier lost ground. In FY2020[1] public sector wages remained on trend, but in the private sector grew by 4.3 percent and above the average, which suggests the possibility of future labor shortages due to both the provision of generous unemployment benefits from the mitigation programs and the strong level of demand in the domestic economy.

> Structural changes in the economy due to COVID-19 mean that current methods of GDP compilation are no longer supportable.

Statistical Issues

Department of Finance and Administration terminated data sharing with Statistics Office. A long-standing issue since FY2016 (and one that is now of growing concern) is the lack of information sharing between the Department of Finance and Administration (DOFA) and the Statistics Office of the Department of Resources and Development (R&D). Data sharing between the two entities was the norm since the start of the 2000s under an MOU (memorandum of understanding) ensuring the confidentiality of the information shared. The confidentiality of proprietary information collected by the Statistics Office is further protected under the Statistics and Census Act PL 5-77 of 1988.

[1] Social Security data for FY2020 is considered preliminary only and based on a reduced sample.

The need for compliance with OECD and Global Forum exchange of tax information between external jurisdictions was given as the reason for termination of interdepartmental data sharing. During the preparation of the FY2016 national accounts, DOFA officials indicated that it would no longer be in a position to provide the information previously supplied, that is, a copy of the Business Gross Receipts Tax (BGRT) rolls, to the Statistics Office due to OECD and Global Forum requirements relating to the exchange of information between jurisdictions. This effectively cut off a major source of information for the compilation of private sector GDP and GDP by industry. As an interim response Social Security information collected annually was used as a proxy for the missing BGRT data. In essence the assumption was made that employee counts were an acceptable proxy for changes in private sector output and value-added. This was a tenable assumption given the slow rate of growth and lack of structural change in the FSM economy. As a result, GDP estimates were prepared for FY2016-FY2019, but these were deemed "preliminary" and published without the industry tables. It was envisaged that the estimates would be revised (and the full set of tables would be published) once the BGRT data-access issue was resolved.

Use of Social Security data as a proxy for tax information is no longer tenable and continuation of the GDP series by private sector and industry is not sufficient. However, as the recent employment data for FY2020 as well as the reduction in output due to the COVID-19 impact indicate, the use of Social Security employment data as a proxy for changes in private sector output is no longer a tenable workaround. The fixed relationship between output and employment (always a second-best proxy) has completely broken down. In FY2020 output fell but employment was maintained as businesses held onto many of their staff, likely with reduced hours. Under these circumstances the GSUSA can no longer estimate the private sector, industry, and GDP series, as the methodology used is no longer fit for the purpose. GSUSA will, however, continue to maintain other national accounts series that it produces in collaboration with the FSM Statistics Office with a view to restarting the series once the "missing" data becomes available to the Statistics Office.

Adoption of data-sharing provisions in the South Pacific provides a way forward and a potential resolution of the issue. A way forward to address this situation is needed. In small nations such as the FSM it cannot be expected that finance and tax offices have the capacity to prepare and edit unit record data suitable for statistical purposes in a similar manner as that of more industrialized countries. However, the Statistics Office has the skills to complete this task and is the appropriate body to set statistical standards and publish series. Recognizing this situation, developments in laws concerning sensitive information have been enacted in other jurisdictions in the South Pacific (New Zealand, Cook Islands, and Niue) These laws are set out as follows:

1. Confidentiality applies only to sensitive tax information. This is essentially limited to tax information that may disclose the identity of the taxpayer or commercial secrets. Aggregated data may be exchanged.
2. Sensitive tax information can be exchanged with officials of other government departments according to memorandums of understanding between departments. This provision will include the Statistics Office, and perhaps other departments, for example, the agencies responsible for anti-money laundering and serious crime.

2. COVID Mitigation Programs and Donor Assistance

Analysis of the response of the public sector and donors to the pandemic can be usefully divided into several components:

1. State and national government core operations
2. National government economic stimulus program and tourism sector mitigation relief fund
3. US and other donor health assistance programs
4. US CARES Act and unemployment assistance
5. ADB COVID-19 Pandemic Relief Option

FSM Econmic Stimulous Package

At the onset of the pandemic the FSM initiated a Tourism Sector Mitigation Relief Fund (TSMRF). In April 2020, shortly after the onset of the pandemic, the FSM president initiated an economic stimulus package, and the FSM Congress initiated a tourism sector mitigation relief fund. The TSMRF was initially credited with a $1 million Congressional appropriation to support tourism-sector operations adversely affected by the pandemic: hotel operators, car rentals, tour operators, resorts, dive shops, and airlines. Affected businesses were eligible to claim relief for 100 percent of wages lost, interest on bank loans, Social Security payments, and Gross Receipts Tax payments.

FSM puts together funding of close to $15 million for the TSMRF. In addition to the $1 million of Congressional funding, resources normally earmarked for the FSM Trust Fund as of April 2020 through the remainder of FY2020 were diverted to the TSMRF. This included the 20 percent fishing fee allocation and the 50 percent allocation of revenues derived from the FSM domicile for Japanese captives and major corporations. The total of funds diverted was estimated at $9 million. In addition, $0.5 million was diverted from the NORMA project development fund and $3 million of the $6 million of resources provided by the ADB under the Pacific Disaster Resilience Program. The total thus secured by the FSM for the TSRMF was close to the FSM's reported figure of $15 million.

Health Mitigation Programs

FSM was the beneficiary of large donations for development of a health response framework. At the onset of the crisis the FSM national government initiated an FSM COVID-19 Response Framework to prepare the nation with a series of steps to mitigate the impact should the FSM become subject to the virus. Donor support for the program was immediate and strong with the US providing the majority (about $29 million) of health-related grants: with $7.7 million under an OIA TA from the US CARES Act, $7 million of unspent Compact sector grants, plus a series of other grants from smaller federal programs such as the CDC. Further health-related funding was available from the World Bank ($2.5 million) and the ADB ($5 million). Given that health services in the FSM are delivered at the state level the vast majority of these funds (90 percent), was utilized by the four state governments.

US Unemployment Benefits - CARES Program

CARES Act unemployment benefits generated significant benefits to affected FSM workers. As in the other Freely Associated States, FSM citizens were made eligible for unemployment support from the US government under the US CARES Act. The program has provided two forms of benefits: Federal Pandemic

Unemployment Compensation (FPUC) and Pandemic Unemployment Assistance (PUA)[2]. The FPUC was initially awarded at $600 a week for four months from April through July 2020. A second phase of the FPUC was awarded from 6 December 2020 through early September 2021 at $300 a week. The PUA has been available continuously since July 2020 and is set to expire in September 2021. A PUA benefit of $166 a week has been awarded during the period. Initial funds of $36 million were awarded and despite some technical issues related to the drawdown process, that full amount remains available to the FSM. In the modeling framework unemployment projections are multiplied by the CARES Act unemployment benefit rates to generate the impact on household incomes.

ADB COVID-19 Pandemic Relief Option (CPRO)

ADB grants $14 million to the FSM to support Livelihoods. The ADB supported the FSM's Health and Livelihoods Support Program (HEALS) subprogram of the CPRO through a grant of $14 million to the FSM to assist businesses and low-income/vulnerable households affected by the pandemic. ADB also granted an additional $6 million to replenish the Disaster Relief Fund. The CPRO contained a series of subprograms:

1. A concessional line of credit through the FSM Development Bank of $3 million to provide support to 200 Small-to-Medium Enterprises (SME).
2. A cash transfer program of $7 million to low-income households that are not beneficiaries of the US CARES Act.
3. A food security program of $1 million for community groups to enhance food production through training and distribution of materials.
4. Community-based small grants of $2 million for NGOs and civil society to enhance COVID-19 awareness.
5. Financial assistance to vulnerable groups ($1 million) for medical expenses, electricity subsidies, solar lamps, and clinical management of family violence.
6. Cash for 900 FSM citizens who are stranded in other parts of the world ($1.2 million funded by the FSM).
7. Temporary unemployment benefits ($0.4 million funded by the FSM) for foreign workers who are not eligible for CARES Act benefits.

Uptake of the cash transfer program for low-income households has been described as rapid. The funds for the CPRO were not received until FY2021 and the modeling framework has estimated that those funds would be distributed on a 75:25 basis between FY2021 and FY2022 for household-related expenditures and 50:50 for the FSMDB. The uptake on the cash transfer program has been reported as rapid, with applications leading to oversubscription and all funds were committed during FY2021. As the program description outlines, the benefits will have a significant impact on low-income households.

> FSM and donor mitigation programs-approximately $75 million (20 percent of GDP)—have had a large impact on household incomes.

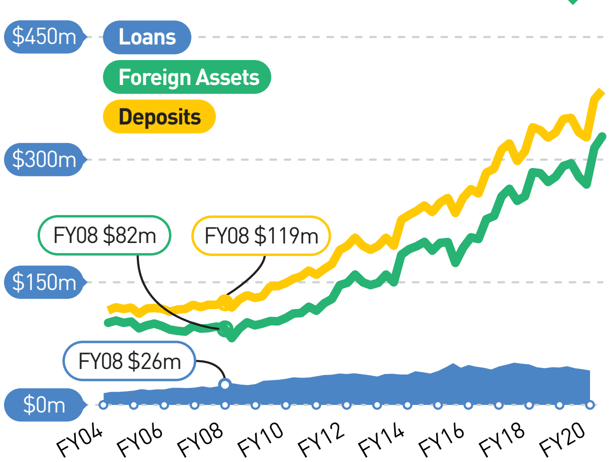
[2] https://dofa.gov.fm/opua/

3. The Financial Sector

Banking

Lending to the commercial sector in the FSM is very low and represents less than 3 percent of deposit liabilities. The deposit base in the FSM banking system ($384 million in FY2020) has grown significantly, reflecting a sound financial system. However, lending performance to the commercial private sector in the FSM has been weak and represents only 2.8 percent of the deposit base, which is one of the lowest rates in the region, see **Figure 6**. The resulting surplus liquidity, now over $361 million, is invested offshore in relatively low-yielding assets. The low rate of domestic lending reflects the perceived high risk of lending in the FSM and "lack of bankable projects." Overall, the inability of businesses to prepare credible business plans and financial statements, the lack of collateral, and the limited ability to use land as security have inhibited development of the financial sector. The lack of a modern tax system that would require prepared financial statements, as well as the inadequate provisions for securing transactions have further impeded financial-sector deepening. With limited local opportunities, commercial banks have preferred to invest their assets offshore in less risky and more secure markets.

Figure 6: Commercial bank lending remains weak; funds invested offshore
Commercial bank deposits, loans, and foreign assets, end of period



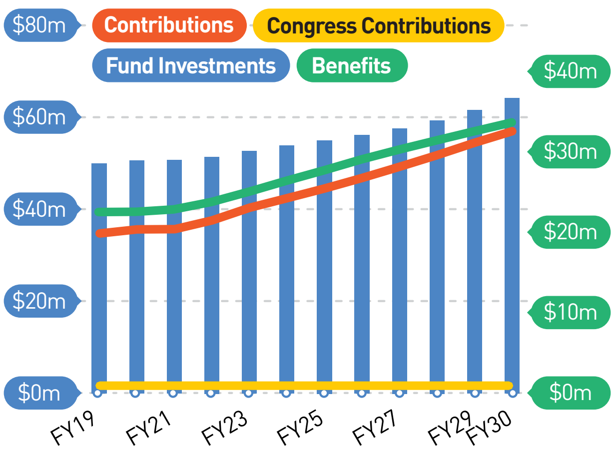
Social Security Sustainability

Financial outturn for SS was favorable in FY2019. As of January 2017, an actuarial assessment of the FSM Social Security Fund indicated an unfunded liability of $286 million as compared to assets of $51 million, a funded ratio of 18 percent. Contributions to the fund in FY2019 were $19.9 million with $22.6 million in benefit payments, that is, contributions covered only 88 percent of benefit payments and Social Security required additional funding to make up the difference for benefit payments. Investment returns were large in FY2019 ($8.3 million) as compared to a $3.1 million loss in FY2018. In recent years the national government has provided a $1 million annual appropriation to support the SS fund. Reflecting these finances, fund investments rose by $7 million during FY2019.

Long-term projections based on Compact renewal look favorable, but under an adverse scenario SS investments would decline. Long-run projections, see **Figure 7**, indicate benefits rising largely in tandem with

> Threats to the FSM Domicile for Japanese companies have now been averted and FSM is deemed to be largely compliant with Global Forum and OECD requirements.

Figure 7: FSM Social Security funds have been sustainable but benefits projected to outstrip contributions in long term
Social Security funds, benefits and contributions



contributions. Benefits are projected to grow at 3.7 percent according to Social Security, while contributions are projected in tandem with wage projections derived from the GSUSA's economic model (MTEF-mod) and grow at an annual rate of 4.6 percent. Investment returns are projected at 7 percent. The resulting outcome indicates fund investments will increase by $14 million and that the Social Security system will remain sustainable. However, the wage projection reflects a bullish Compact renewal scenario post-FY2023. If Compact renewal turns out less favorable and there is no further provision of the Compact sector grants, wage growth is estimated to be reduced to 3.1 percent. In these circumstances fund investments would decline by $8 million to $42 million from the current $50 million. These simulations suggest the Social Security system should be carefully monitored. While the current position is favorable, if the economy fails to grow, the outcome will look less positive.

FSM Domicile for Japanese Companies

FSM has benefited mightily from the creation of the FSM domicile for major Japanese corporations. In 2005 the FSM passed corporate tax legislation that enabled the creation of an overseas domicile, which has primarily targeted Japanese companies. The law provides for a corporate tax rate of 21 percent, and through differential tax rates, the FSM host environment provides an attractive domicile for Japanese captive insurance companies and other corporations. The benefit of these arrangements has been a steadily growing stream of revenues to the national government, which includes a relatively steady $10 million in recent years from captive insurance companies, as well as occasional capital gains-related tax revenues from major international companies. In FY2014 there was an unusually large receipt of $28 million, which reflected a large declaration of capital gains by one company. In FY2017 there was another large receipt ($23 million) by one corporation. In FY2018 there was a receipt of $77 million from yet another Japanese organization, and in early FY2019 there was a receipt of $62 million. Although large payments can be expected periodically, FY2018 and FY2019 were exceptional.

FSM's efforts to respond to a severe threat resulted in the FSM now being deemed largely compliant with Global Forum and OECD requirements. A particular area of concern has been compliance with the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Global Forum is a group of 162 members that are working under the guidance of the OECD to create a transparent environment among nations in the sharing of information in the tax area; the FSM is not currently a member. In the first round of peer reviews in 2015 the FSM was deemed noncompliant. As a result of this Global Forum noncompliance, the FSM enhanced its compliance efforts and passed legislation on transparency and the exchange of tax information. A second peer review was undertaken in 2019 and found the FSM to be largely compliant.

Risks exist should Japanese lawmakers enact stronger provisions toward offshore tax domiciles. Additional risks to the industry have resulted from changes in Japanese corporate law concerning tax- haven status. In addition to requiring foreign jurisdictions to have an income tax burden in excess of 20 percent, foreign-domiciled companies are required to display substantial business activity rather than being paper or post-office-box operations. The exact nature of displaying substantial business activity is not precisely known, but the FSM authorities insist upon a physical office and an administrator for each Japanese subsidiary in the FSM. Most corporations hold board meetings in-country to further confirm their domicile within the FSM.

FSM domicile revenues are not subject to revenue sharing but an unknown level of risk exists if competition should emerge between FSM states. At present the industry resides primarily in Pohnpei. Although corporate taxes generated from the FSM domicile are not treated as subject to FSM revenue sharing, they only generate direct revenue to the national government. However, the current arrangements are the subject of two court cases. Both cases appear to be under a form of voluntary suspension due to inaction by the plaintiffs, and no court decisions have been made. An internal domestic dispute is feared, as it might lead to a loss of confidence among Japanese companies and a consequent loss of revenue for the FSM. It is well understood that businesses prefer (and tend to perform better in) an environment of stability and predictability. Policy or policies to avoid an upset to the current arrangements under the domicile for Japanese corporations might be addressed as part of the recommendations of the National Tax Reform Commission (see following section).

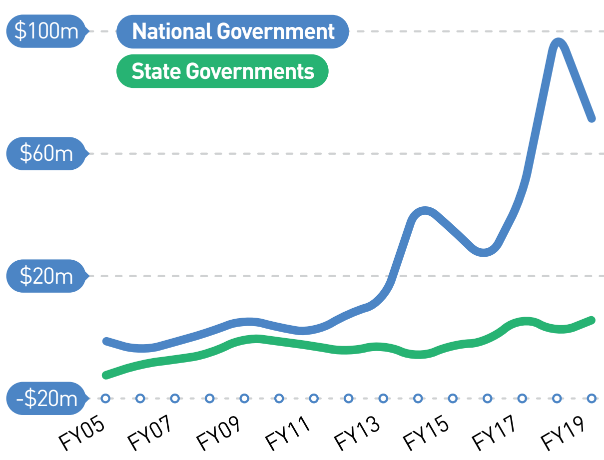
> The national government ran a large fiscal surplus (close to 20 percent of GDP) during FY2015-FY2019, as state budgets remained severely constrained.

4. Fiscal Performance and Reform

The Fiscal Outturn

State governments have run a balanced fiscal policy. The FSM government comprises four state governments and a national government, with much of the responsibility for public service provision—including education, health, and public safety—held primarily by the state governments. With declining inflation-adjusted Compact sector grants and little or no growth in domestic revenues at the state level, service delivery and public expenditures have been severely constrained. Despite these challenges, the state governments have adopted a prudent approach to fiscal policy and have maintained a small fiscal surplus averaging 0.5 percent of GDP, FY2015-FY2019, see **Figure 8**.

Figure 8: National government achieves large fiscal surplus as State governments attain balance
Fiscal balance: state and national governments



> FSM maintains a low external debt profile without serious risk of debt stress.

National government runs large fiscal surpluses. At the national government level, fiscal conditions are markedly different. In addition to tax revenues shared with the state governments, the national government benefits from the receipt of sovereign rents from fishing royalties under the Parties to the Nauru Agreement and implemented through the Vessel Day Scheme. Fishing royalties have grown steadily from a level 5 percent of GDP at the start of the amended Compact, to an average of 21 percent of GDP from FY2015 through FY2019 with minimal volatility, see **Figure 9**. In FY2019 receipts from fishing licenses were $73 million. The national government has also established an FSM tax domicile, primarily for Japanese captive insurance and major corporations. While this normally represents less than 2 percent of GDP, its value to the national revenue base spikes periodically. In FY2018 and FY2019, for example, it averaged 24 percent of GDP due to receipt of large tax declarations (capital gains) by major corporations. The combination of fisheries revenues and the tax domicile revenues has resulted in large fiscal surpluses for the FSM national government. During FY2015-FY2019 this large structural surplus averaged 19 percent of GDP, peaking at 30 percent in FY2018, see **Figure 10**.

Large fiscal surplus has supported rapid growth in the nation's own FSM Trust Fund. The large increase in resources has been utilized in two major ways. First, and most importantly, the FSM has created a national trust fund (FSMTF) and increased its holdings of uncommitted funds. Notably, about two-thirds of the additional resources have either been allocated to the trust fund or remain unspent. At the end of March 2021, the FSMTF is estimated to be close to $350 million, which is a significant and impressive amount. The national government is thus committed to adding about $24 million annually to the fund (under conservative estimates), although during the COVID-19 pandemic period a portion of these funds has been diverted into the economic stimulus package and tourism sector mitigation relief fund.

Fiscal surplus has led to large growth in congressionally based projects and increases in the use of goods and services. Second, the increase in resources has permitted significant growth of national government congressionally specified projects and increased national

Figure 9: State government domestic revenues stagnate as National revenues boom

National and State government domestic revenues

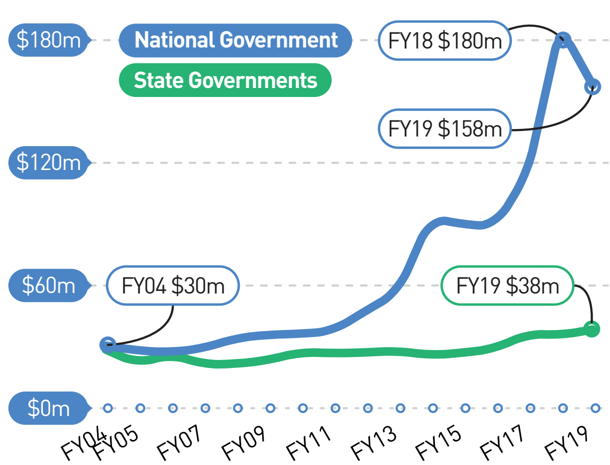
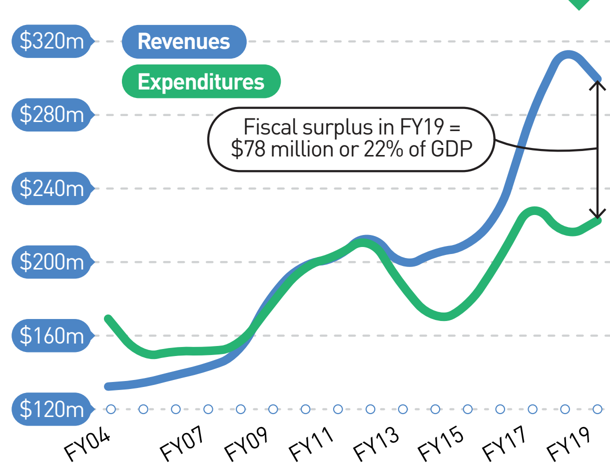


Figure 10: FSM generates large fiscal surpluses after FY2013 with rising fishing fee and corporate |tax revenues

FSM consolidated revenue and expenditures



government expenditures on goods and services. Since these expenditures are nonrecurrent in nature, the true level of discretionary fiscal space and underlying structural surplus available is considerably larger than that represented as the annual surplus in the fiscal statistics. While it might be argued that the increase in the FSM's resources has represented a lost opportunity in service delivery at the state level, the national government has purposely avoided a destabilizing rise in state-level recurrent expenditures, which would surely be unsustainable after FY2023 in the (now seemingly unlikely) event of an unfavorable outcome of the on-going Compact renewal negotiations.

Tax Reform

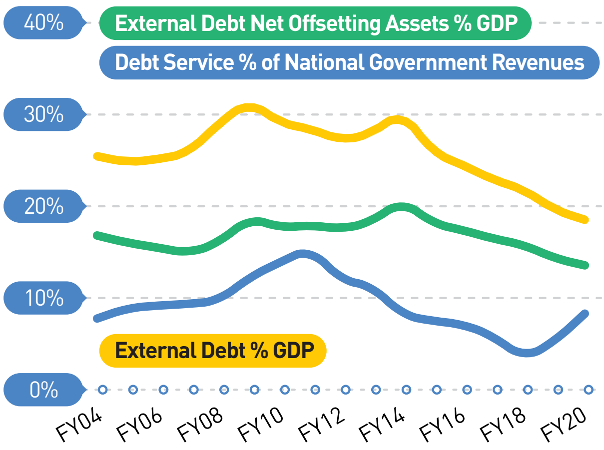
FSM tax reform has been low on the agenda but warrants reconsideration as the nation pulls out of the COVID-19 pandemic and enters a new Compact era. In the mid-2000s the FSM embarked on a lengthy process of tax reforms, which, after many years of donor support and hard work by officials of all five governments, has not yet led to adoption. With a tax/GDP ratio of 13 percent, ignoring FSM-domicile corporate taxes (average FY2017-FY2019), FSM tax effort has been low, and a tax reform initiative presents an opportunity to adjust to future fiscal shocks and to create an efficient tax environment that supports private sector development. Two of the four FSM states (Chuuk and Kosrae) supported the tax reform initiative. Yap State, while expressing no objection to the reforms indicated that the proposal was unconstitutional with respect to Yap's state constitution, and thus declined to participate. There was some renewed recent interest from Pohnpei State, where a disproportionate benefit from tax reform would accrue, but this interest now appears to have waned. There is clearly little incentive for additional revenue effort by the national government due to booming sovereign rents and given that, under current arrangements, 70 percent of the domestic taxes accrue to the states. However, if the FSM wishes to improve revenue buoyancy, and the ability to support development into the new Compact era, reconsideration of the tax reform and a modernization effort should be high on the FSM agenda.

The FSM president's recent announcement of the creation of a National Tax Reform Commission indicates a stated purpose "to find a means to improve citizens' livelihoods, expand and update the Nation's revenue base, and attain or implement the equitable sharing of revenue between the Nation's States of Yap, Chuuk, Pohnpei, and Kosrae." It will be important that the entire revenue regime—not just the outdated aspects of the tax regime—be studied. Similarly, it will be important that the focus on equitable sharing of revenue "between the Nation's States" be interpreted to include sharing of revenue among the nation's five governments. The last time the FSM adopted a fundamental revenue-sharing policy outside of the original terms of the FSM Constitution, was prior to the outset of the original Compact economic assistance period that started in FY1987. Given the massive changes to the revenue base since then and the impact on national and state shares of revenues, the president's commission is timely assuming its scope is sufficiently broad.

External Debt

FSM has an admirably low external debt profile. The FSM's external debt, at 15 percent of GDP and 11 percent net of offsetting assets (sinking fund), is one of the lowest in the region. Debt service of 5 percent of national government domestic revenues remains well within the capacity of the national government to service and does not present any threat of debt stress, see **Figure 11**. A recent review by the FSM public auditor revealed many weaknesses in the FSM's external debt management. As a result, a debt management bill has been drafted but has yet to be acted upon by the FSM Congress. Addressing debt management as part of improving Public Financial Management (PFM)

Figure 11: External debt low as a percentage of GDP and remains sustainable
External debt ratios



sooner—while debt distress is not a concern—rather than later is advisable.

FSM has been accorded "grant only" status and is benefiting from large increases in external aid. While this analysis indicates that the FSM is not at risk of debt distress, the standard World Bank/IMF Debt Sustainability Analysis (DSA) places the FSM in an at-risk category. The DSA analysis assumes that large fiscal shortfalls projected post-FY2023 would be financed through (hypothetical) concessionary external borrowing. However, the FSM does not have access to the assumed persistent borrowing from global capital markets or even from donors, especially for maintaining operational expenditures. While the World Bank/IMF's assumptions may differ from what would actually transpire if the FSM experienced a severe post-FY2023 fiscal shock, the consequence of the DSA is that the FSM has been accorded "grant only" status for access to resources. Under the current round of World Bank IDA 19 funding, the FSM is thus not eligible for loan finance, but does qualify for up to $25-$30 million of grants annually. In addition, with increased grant allocations averaging $15 million from the Asian Development Bank and other major donors, the FSM is currently benefiting from a large increase in grant-only external aid compared with historical levels.

5. Public Financial Management

Public Expenditure and Financial Accountability (PEFA)

FSM has adopted PEFA but rollout at the state level is required for effective implementation. In 2010 the FSM conducted a PEFA self-assessment, a scored system of PFM established by the World Bank. After little action in the subsequent years, a renewed self-assessment was conducted in 2016 with the support of PFTAC, which led to development of a "Road Map." The Road Map provides a list of targets for reform against which progress can be monitored. Progress in this area is a standard condition of eligibility for budgetary support from some donors such as the European Union and the World Bank. Since preparation of the Road Map, the FSM has focused on a set of key areas, including implementation of both a new Financial Management Information System and Financial Management Procedures. To be of value throughout the FSM, the PEFA exercise needs to be rolled out to each of the FSM states, where most of the public expenditures take place. To this end the EU is providing technical assistance support to develop PEFAs for each of the four state governments.

Financial Management Information Systems (FMIS)

New FMIS is to be implemented in the FSM with World Bank support, but progress has been slow due to a series of implementation issues. The current FMIS in the FSM is nearing

> Clearly, the most efficient and effective solution is ownership of all submarine cables by one entity. At present the fiber connections are owned and managed by two separate entities: FSM Telecom and the Open Access Entity.

the end of its effective life as its software company is ceasing to support a declining user base. With donor grant support from the World Bank, a replacement system is being pursued. A project manager was hired and consultants selected to guide the FSM through needs assessment, development of an RFP, and selection of suitable software. However, the project has suffered from a series of management issues with the replacement of key implementation staff. Enhanced reporting and a well-formulated chart of accounts should enable improved information for fiscal management and performance budgeting.

New Revenue Management System will greatly assist revenue collection and potentially improve the statistical information base. In addition to procuring a new FMIS the FSM requested support from the World Bank to implement a new Revenue Management System (RMS) to interface with the FMIS. The initial phase of the RMS will be the establishment of a tax register of businesses and the issuance of Tax Identification Numbers. A project manager has been hired and an IT expert is to be recruited. The intention is to issue an RFP by year-end and for implementation to follow shortly thereafter and before the start of the FMIS. The new RMS will greatly assist in the provision of statistics for calculating GDP by industry as discussed above.

Public Sector Payroll

Size of civil service has declined during the amended Compact and wages have risen on average by 2 percent per annum. As public payroll currently represents a high proportion of GDP, the careful monitoring of trends is essential in anticipation of an uncertain level of resources post-FY2023. The proportion of public sector payroll has been slowly declining since the start of the amended Compact from 21 percent of GDP in FY2004 to 15 percent in FY2019, before the pandemic. This reflects both the substantial workforce reductions in Chuuk and Kosrae and the recent growth in the economy at a rate greater than the increase in public sector payroll. From the start of the amended Compact in FY2004 through FY2020 the number of public servants has declined by 3 percent. However, the wage bill increased by 29 percent during this period, reflecting a 1.7 percent annual average increase in nominal wage rates. It is unclear if the FSM (at least at the state level) can sustain this rate of increase in the wage bill without further fiscal adjustment if one considers the relatively stagnant economy and the static nature of nominal Compact sector grants.

6. SOE Performance and Reforms

The Power Sector

Lack of adoption of full cost- recovery pricing in the utility sector in each state has led to inefficient operations, especially in Pohnpei. The FSM has managed to operate the SOE sector without the need for large subsidies. However, weak pricing policies in the utility area have led to inefficient operations and lack of replacement of capital. While Chuuk now has a 24-hour daily supply of electricity and an improved sewer and water treatment system, Pohnpei has suffered from load sharing, while central components of its sewer system need rehabilitation. In Yap, the utility corporation charges the government twice the normal price to maintain a positive cash flow. Moves are underway at Pohnpei Utility Corporation to reform the ailing utilities along the lines of the Chuuk reform initiative through a jointly financed reform program with funding from the World Bank, the Asian Development Bank, and the US. Current indications are that the key parties in Pohnpei state are prepared to endorse and fully implement the comprehensive reforms and practices that resulted in success in Chuuk state. Meanwhile, it is essential that the Chuuk utility continues its focus on sound management, maintains its reform stance, and avoids any reversal toward poor practices that led to disastrous results in the past.

Telecom and Information and Communication Technology (ICT) Reforms

World Bank supported FSM-led reforms to the ICT market. The World Bank has been supporting ICT reform through a series of nationally legislated reforms and the provision of grants. The initial phase of the project has been to lay a fiber-optic connection ($47.5 million) to Yap and Chuuk. The reforms included a new law in 2014 permitting competition in the ICT market, the establishment of a Telecom Regulatory Authority, and creation of an Open Access Entity (OAE) to own and operate the new fiber asset. All three components have now been operationalized and the TRA has issued regulations. The ICT reform process envisages open access to the fiber network to all potential service providers enabling the onset of a competitive market.

World Bank support to the FSM's long-standing reforms has been met with resistance from the incumbent telecom provider. While progress has been made, the project has been fraught with issues and resistance to reform. An initial lack of agreement on the terms of access to the existing HANTRU cable (providing access between Pohnpei and Guam) was eventually resolved through the issue of an Indefensible Right of Use, guaranteeing the OAE access to the new cable at no cost. Clearly, the most efficient and effective solution is ownership of all submarine cables by one entity. At present the fiber connections are owned and managed by two separate entities: FSM Telecom and the OAE. The new cable connections to Yap and Chuuk are now operational.

The World Bank invests in further ICT projects, fiber connectivity to Kosrae and Digital FSM, but encounters further resistance from FSM Telecom. Continued funding under the World Bank regional project agreed upon by the Bank's board known as the East Micronesian Project ($30.8 million) will connect Kiribati, Nauru, and Kosrae to the Pohnpei HANTRU spur. An RFP has been issued for the project, but issues have arisen with the use of Huawei equipment by the selected (lowest bid) vendor, and the bid has been canceled. A new World Bank project agreed upon by the board in March 2020 and known as Digital FSM ($30 million) is designed to enhance internet use in education and health, promote eGovernment, and provide fiber connectivity to target locations and homes. In order to compete with the OAE, FSM Telecom has started to lay fiber to the home/premises in Pohnpei and Yap. Relatedly, the OAE initiated legal action and an injunction against FSM Telecom to cease installation of fiber to the home and/or key premises on the grounds of FSMTC refusing to acknowledge its obligations under the IRU Deed and not paying for use of the Yap and Chuuk cables. Clearly, the action taken by FSM Telecom defeats the objective of wholesale service provision by the OAE. In all, the FSM will have been the beneficiary of a total of over $100 million for enhanced ICT connectivity.

The FSM needs to rationalize the ongoing disputes and inefficient duplication of resources within the ICT market. The government of the FSM has established an ICT environment conducive to widespread uptake of modern ICT services. A wholesale provider, the OAE, has been created, together with a regulator. A law permitting competition and regulation has been passed, which sets the regulatory environment. However, the project has encountered continual resistance from the incumbent provider arguing that the FSM is too small for more than one provider with the long game of outlasting World Bank involvement. This has resulted in delays, legal cases, and duplication of infrastructure. The FSM needs to fully endorse the ICT project created with significant resources, rationalize the use of infrastructure, respond positively to a changed environment, and focus on the provision of efficient and competitive services to the consumers of the FSM.

FSM PetroCorp and Coconut Products for Export

FSM PetroCorp is a welcome example of a persistently well-run SOE. The FSM PetroCorp was created in 2007 to take over the operations of the departing supplier, Mobil. The transfer proceeded well and PetroCorp was able to achieve an annual return on capital of 13 percent between FY2010 and FY2017, which exceeds the original target of 10 percent. While FY2018 was a poor year of financial performance, in FY2019 performance improved and the company recorded a profit rate of 5.2 percent. As the level of retained earnings and the capital base has risen, profitability has fallen, which reflects a largely static level of net income. The advent of the COVID-19 pandemic had significant impact on fuel sales (down 17 percent) in FY2020, reflecting a significant fall in aviation gas and marine fuel sales. PetroCorp has now opened diversified operations to Guam and Nauru and is a welcome case of a consistently well-run SOE.

Diversification into copra processing is a high-risk venture. A bill before Congress entitled the "Transformation Act" is intended to provide clarity on the mission of PetroCorp. The bill indicates the need to transform the business model from a successful fossil-fuel importer to (i) a low-cost carbon-free energy supplier and (ii) an exporter of high-value agriculture products. It is in the latter aspect that recent plans to expand horizontally through the opening of a coconut processing facility in Tonoas, Chuuk, that PetroCorp faces a risk to its capital base. While the project has been well designed and researched, investment costs are likely to escalate. Clearly this activity falls

> PetroCorp has performed well; however, the coconut venture is high risk and requires separation within the audit to monitor its developments.

under the domain of venture capital, and it begs the question: should high- risk projects be fully funded by public funds? For an industry that has been in decline in the Pacific for many years, with labor in short supply in similar low-wage activities, and a declining raw-material supply (due to aging coconut trees), the odds of success are not favorable. While technology has changed in the copra sector with potential for processing the whole product and production of virgin oil, the market is dominated by the Philippines, which provides 70 percent of the world supply at low cost. Typically, government-sponsored venture capital projects allocate investments where private sector investors have taken the lead and the public funds form a minority portion of the total investment.

In the post-COVID-19-pandemic period PetroCorp should consider concentrating its mission on energy diversification, stay close to its core business, and start paying dividends. The objective in the Transformation Bill to reorientate PetroCorp toward the supply of low-cost, carbon-free energy is well received. However, for the reasons expressed above the new mission to become an exporter of high- value agricultural products needs re-evaluation. One of the earlier justifications for the diversification was the looming end of the economic assistance terms of the amended Compact and the need to find alternative areas of development to fill the gap. Presumably, the loss of income and reduced job opportunities would place downward pressure on wages making the coconut project seem more attractive. However, the US has indicated its intention to renew the terms of economic assistance under the Compact and the assumption of a low-cost ready supply of labor may not be forthcoming. Out-migration to the US is a significant factor in limiting the expansion of the domestic labor supply. This Briefing Note thus recommends modifications to the objectives of the Transformation Bill, with replacement of the objective to export high-value agriculture products with the requirement that PetroCorp refocus on its core business and start paying dividends. This may seem radical in the context of the FSM; however, well-functioning SOEs elsewhere in the Pacific and around the world are expected to pay dividends as a return on the public capital that supports their operations.

To evaluate performance PetroCorp should provide disaggregated information in the annual audit on the coconut project. In the interests of transparency and accountability, it is important that information about each PetroCorp project (cost center) be separated in the financial statements. Public-audited information should identify cross-subsidization, and each discrete business activity should be carefully monitored to show its true costs.

7. Private Sector Developments

Fisheries and the Domestic Fleet

The Parties to the Nauru Agreement and Vessel Day Scheme have proven to be highly beneficial to the FSM. Fishing in the region now effectively comes under the Parties to the Nauru Agreement (PNA), a cartel of 9 Pacific Island states including PNG, which has led to a remarkable and sustained increase in member country revenues from the Vessel Day Scheme (VDS) and sale of vessel days. The PNA has led to a fivefold revenue increase for the FSM since the start of the amended Compact period. Daily fishing rates average close to $12,000 per vessel day from which the FSM received $73 million of revenues (18 percent of GDP) in FY2019. Each PNA member is accorded a Party Allowable Effort (PAE) that is set in relation to the size of its fishery. The PAE for the FSM averaged 7,300 vessel days between 2015-2018 and this number is reported to have recently increased.

The FSM arrangement (FSMa) provides large discounts to promote development of the local fishing industry. The "domestic" purse-seine fishing fleet comes under a regional arrangement among Pacific nations, known as the FSM arrangement (FSMa), whereby the owners pay a reduced daily rate, which has been negotiated between the host nation and the respective operators. This negotiated rated is paid for fish caught in the FSM; however, the rate for fish caught by FSMa vessels in another FSMa jurisdiction requires a $4,000 transfer fee. The FSMa was established to encourage the development of the local fishing industry. However, there is significant debate as to whether the domestically flagged vessels make a significantly greater contribution to the economy than third-country fishing vessels, which operate without a discount.

Estimates of the loss of the FSMa (due to economic costs exceeding benefits) may be substantial. The justification for registration under the FSMa is that domestically flagged vessels generate an economic benefit greater than or equal to the discount. Estimating the gross loss in VDS sales; the difference between the spot price for a VDS day and the average FSMa price is problematic. However, with 28 vessels fishing for 200 days a year with an average discount of $4,000 per day, the annual gross loss would be $22.4 million. Against this must be deducted the economic benefit of a vessel day. A recent unpublished study conducted by the GSUSA in 2019 suggested that the net benefit of an FSMa day compared with a bilateral day was about $700. This would imply a revenue loss to the national treasury of the full $22.4 million discount but a slightly reduced loss of $18.5 million to the economy.

There is a need for a transparent evaluation of the FSMa so FSM policy makers can make informed and evidence-based decisions on the rationale for, and size of, the discounts. The above hypothetical estimates are provided to illustrate the magnitude of the potential loss to the FSM. Thus, careful evaluation of the benefits of domestic flagging of vessels under the FSMa is needed; as while the private owners make substantial gains, this may be at the expense of the local economy and the national treasury. This issue has been in question for some time due to the lack of transparency of the underlying economics of the arrangements. Only when there is full disclosure can FSM policy makers

> The domestic purse-seine fishing industry requires transparent evaluation to estimate its costs and benefits to the economy.

make informed and evidence-based decisions on whether the discounts provided are worth the cost. PNG, for example, is reported to provide a discount or rebate to PNG-flagged vessels only upon presentation of proof of benefits derived from employment and purchases of goods and services in the local economy.

The World Bank's "Doing Business" Survey

The World Bank's "Doing Business" survey paints a discouraging view of the environment for private sector growth in the FSM. Out of 190 countries the FSM currently ranks at 158 (83 percent down the list), indicating much room for improvement. The FSM fares slightly worse than Palau and the RMI, which are ranked at 145 and 153 respectively, and the FSM is substantially below most of the South Pacific nations. Sāmoa is ranked 98, Tonga 103, Vanuatu 107, Fiji 102, and Papua New Guinea 120. Overall, the FSM's scores are generally weak. In the areas of registering property, protecting investors, and enforcing contracts the FSM's scores rank between 184-187, which are some of the worst scores of all countries surveyed by the World Bank. Slightly higher up the list the FSM registers its best score (65) for trading across borders and its second-best score (104) for obtaining credit.

Foreign Direct Investment

Effort to reform and streamline the foreign investment regime runs up against state-national jurisdiction issues. The existing Foreign Direct Investment (FDI) regime in the FSM was established as part of a set of reforms sponsored by the ADB in the late 1990s. FDI provides for a two-part system that divides jurisdiction for investments between the national government (for investments of a national character) and the state governments (who handle all other investments). However, this system is cumbersome and results in a complex licensing process. In 2016 further reforms were introduced in the FSM Congress to modify the 1997 FDI Act bringing all foreign investment under the jurisdiction of the national government. The reforms effectively claim that all foreign investment is, by its very nature, of national character. While the reforms would streamline the FDI process and should be supported, they have so far failed to pass through Congressional committee review to be considered for enactment. Changing jurisdiction in an area formerly under state control will take considerable effort.

8. Structural Issues

Structural surplus and contributions to the FSM Trust Fund

National government runs large fiscal surpluses. The boom in national government revenues derived principally from fishing fees as well as large periodic gains from corporate taxes from FSM-domiciled Japanese companies, which have led to large fiscal surpluses for the national government. In FY2015 the national government ran a fiscal surplus of $35 million (11 percent of GDP). This surplus rose to $98 million (28 percent of GDP) in FY2018 and fell to $71 million (20 percent of GDP) in FY2019 (see Figure 8). Without considering any possible windfall gains from the FSM domicile, the fiscal surplus is projected to have fallen to a still strong $24 million or 6 percent of GDP.

Large fiscal increase in revenues has enabled a large increase in expenditures on goods and services and Congressional district public projects. While revenues have grown rapidly the increase in fiscal space afforded by the increase has also enabled a large increase in expenditures on the use of goods and services and Congressional district projects. From an annual average of $19 million during the period of FY2009-FY2013, the use of goods and services rose to $48 million in FY2019, which may be partially attributed to World Bank spending, which is not segregated in the FSM's Financial Management Information System Chart of Account. Still, outlays on public projects have risen from an average of $3.3 million during the first 9 years of the amended Compact to $28 million in FY2019. Taking these rapid increases into account, the structural fiscal surplus at the national government level can be estimated: rising from $5 million (1.7 percent of GDP) in FY2011 to $70 million (21 percent of GDP) by FY2019.

Analysis of the structural surplus indicates the national government has saved about two-thirds of the available funds: a significant achievement. An analysis of the total structural surplus generated from FY2015 through FY2019 yields a figure of close to $497 million. Of this $177 million was utilized for increases in expenditures on use of goods and services and Congressional district projects above the FY2015 inflation-adjusted level. Thus, the FSM national government spent just 34 percent of the surplus while saving the balance of the surplus, primarily in the FSM Trust Fund.

National government commits to contribute close to 7 percent of GDP annually to the FSMTF. The national government has been allocating a significant part of the fiscal surplus to the FSM Trust Fund (FSMTF), and the corpus is estimated to be close to $350 million at the time of writing. Under a series of public laws (and in particular PL18-107 and PL20-134), the national government has specified annual commitments to the trust fund. Under PL18-107 the national government allocated 20 percent of its share of domestic taxes to the states (approximately $6 million). Under PL 20-134 it allocated 50 percent of the earnings of corporate taxes from the captive insurance and large corporations' sector to the FSMTF (approximately $5 million in normal years). It further allocated 20 percent of fishing-fee revenue to the trust fund (approximately $14 million). In total the national government has mandated the contribution of conservatively $25 million annually to the FSMTF. That number will rise substantially in years with large receipts from FSM-domiciled companies.

Favorable outcome in Compact economic assistance renewal negotiations will challenge the FSM to adopt changes to the balance of national and state fiscal operations and application of resources to

> Put simply, the FSM's fiscal situation begs for a profound and long-term restructuring of national and state fiscal operations. Such a task has been understandably difficult to even discuss—much less achieve—in the presence of post-FY2023 uncertainty.

meet development priorities. The boom in sovereign rents has enabled the FSM to save considerable resources in the FSM Trust Fund. With two full years left before the expiration of the economic assistance terms of the amended Compact, the nation has built up a fairly large cushion, which could be relied upon in case of an unfavorable renegotiation or the sort of delay in funding that occurred to Palau in 2010 (when agreement was reached with the US, but funding was not appropriated until 2018). The FSM has set aside these resources to support the nation in the event of a disappointing result post-FY2023. The FSMTF also integrates responsibilities to support the FSM in the event of climate change-related or other national emergencies. However, if, as has been assumed in the projections in this *Briefing Note*, there is a favorable Compact renewal result, the FSM will be faced with a new challenge of how to use the nation's sovereign-rent resources in a productive and efficient way for its future development. This may challenge the FSM to move away from a resource allocation process controlled at the national level to an allocation process that would be driven proportionally more at the state level. Alternatively, the result may be a reordering of service-delivery responsibilities in order to achieve a better balance in relation to fiscal operations. As noted above, a sufficiently broad interpretation of the duties of the newly created National Tax Reform Commission may be a good vehicle to identify options for the nation's leadership to consider.

Infrastructure and the Economy

The large unused Compact infrastructure resources have now grown to nearly $250 million (61 percent of GDP). The implementation of the Compact infrastructure grant was slow at the start of the amended Compact due to capacity constraints. However, by FY2012 implementation issues had been overcome and expenditures exceeded that year's grant allocation of $22 million by $5 million. Improved performance was short-lived, and a series of issues plagued implementation with utilization falling to $5.3 million in FY2019. Out of a total estimated allocation of $384 million since the start of the amended Compact, the FSM has only been able to use approximately $138 million, leaving approximately $246 million (61 percent of GDP) of unspent resources.

A series of issues and now COVID-19 have resulted in continuing delays and very low use of the Compact infrastructure grant. Project management issues, lack of clear priorities—or perhaps, more specifically, a mismatch between FSM-stated priorities and Compact language. The prioritization of health and education infrastructure, the JEMCO requirement to prepare an updated Infrastructure Development Plan (IDP), the inability or unwillingness to provide professional engineers and contract management staff to the level required by JEMCO, and the perception within the FSM national government that requirements for proceeding were either unclear or frequently changing over time led to further delays. By 2016 an Infrastructure Development Plan (IDP) was prepared to set priorities, but project management issues remained. After further delays, in June of 2017 a resolution between the US and the FSM was reached to remove the suspension of the grant. Subsequently, the national project management unit (PMU) was partially reorganized, and each state established its own project management office (PMO). As part of the resolution, under pain of continued suspension, the US Army Corps of

Engineers was made available to respond to state PMO requests for technical assistance especially where the Corps can enhance project design and implementation through its BCOES process (which entails a review to ensure each project is Biddable, Constructable, and Operable meeting Environmental and Sustainability standards). Unfortunately, within two years of finding a workable way forward, COVID-19 descended on the world and travel restrictions placed yet further delays on use of the infrastructure grant.

The delays in use of the infrastructure grant have been costly to the FSM economy in lost opportunities and in slower growth. After adjusting to the new conditions of the amended Compact, the economy performed favorably buoyed by greater use of the infrastructure grant and FAA airport improvement projects. However, as construction demand dried up in the following three years FY2012-FY2014 the economy contracted by 8 percent. While much of the loss was due to the completion of large FAA airport improvement projects, a major part was due to the decline in the use of the infrastructure grant. This emphasized the importance of maintaining the stimulative role in the use of the infrastructure grant. The large reservoir of unspent resources presents an opportunity to re-invigorate the FSM economy in the post-COVID-19 recovery period during the remaining years of the amended Compact period and then into the renewed Compact period. However, care should be taken to ensure that resources are spent conservatively, to prevent the boom-and-bust cycle that has afflicted the FSM.

Long-Term Planning

Use of FSM sovereign rents has followed an ad hoc process that included admirable levels of savings. In 2012, the FSM initiated an exercise (2023 Action Plan) to plan for the transition to an amended Compact after FY2023. However,in 2012 the post-FY2023 future was highly uncertain and the Compact Trust Fund lacked sufficient resources to support the ongoing level of government operations. The Plan, while focusing on the post-2023 era, also addressed the use of an emerging national government structural fiscal surplus. However, since 2015, and during the COVID-19 era, the 2023 planning effort has been inactive. Rather, in the absence of a formalized plan, the FSM Congress has saved about two-thirds of fiscal surplus, primarily in the FSM Trust Fund with the remainder allocated to Congressional District projects and increased nonrecurrent expenditures. While the additional spending might have been more efficiently and effectively utilized, the contributions to the FSM Trust Fund resulted in the Fund growing to $350 million by mid-FY2021, a remarkable achievement.

The 2023 Action Plan, or something of similar scope, needs to be revisited as the nation emerges from the COVID-19 pandemic. Clearly, there is a need for a rational approach to economic management and allocation of significant sovereign resources. The former 2023 Plan established a useful framework for resource allocation and a renewed focus on private-sector development and selective policy reforms. As the FSM recovers from COVID-19 and details of an amended Compact become clear, the government would be well-advised to revisit the former 2023 Plan, or a modified version of the Plan, to ensure the best use of readily available funds in the FSM's future. Both the annual sovereign-rent stream and earnings from the FSM Trust Fund might be used for development needs in the states as the current policy of saving surplus funds to the Trust Fund to avoid a post-FY23 fiscal shock may no longer be necessary. Put simply, an amended Compact will remove the longtime uncertainty about the Compact's future and allow for a profound and long-term restructuring of both national and state fiscal operations. A broad interpretation of the newly created National Tax Reform Commission would enable the nation's leadership to identify new fiscal options for the future.

9. Compact Issues

The magnitude of fiscal risk (if Compact economic assistance terms are not beneficially renewed) approaches 20 percent of pre-COVID-19 levels of GDP. This potential risk highlights the importance of the bilateral negotiations that are set to continue in 2021.

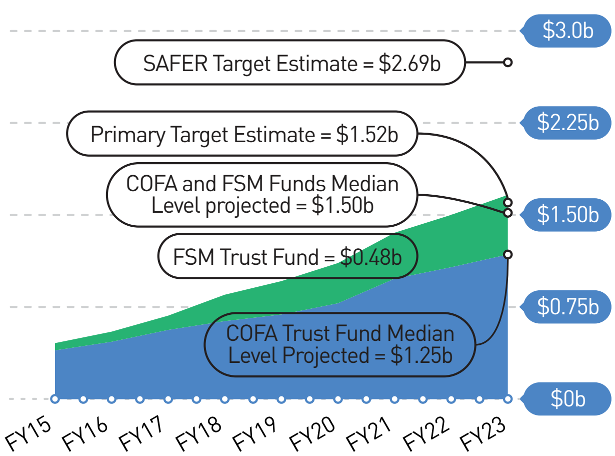
The FSM Compact Trust Fund (FY2019 & FY2020)

Two years of continued contributions and market-driven growth resulted in a balance of $784 million in the Trust Fund at the end of FY2020. The FSM CTF experienced market gains of 3.2 percent during FY2019; these gains, combined with a scheduled contribution from the US of $32.2 million at the outset of the fiscal year, enabled the fund to grow by $53.4 million to a balance of $690 million by the end of FY2019. In FY2020, the FSM CTF experienced market gains of 8.4 percent, which (with a scheduled contribution from the US of $33.8 million at the outset of the fiscal year) enabled the fund to grow by $94.4 million to a balance of $784 million by the end of FY2020, see **Figure 12**. During the period of investment since FY2007, the annualized rate of return has been 6.7 percent.

It is unlikely that the FSM CTF will perpetually be able to replace FY2023 grants. The fund would need to grow at 22.7 percent annually from FY2021-FY2023 to achieve a level sufficient to provide a smooth transition to CTF distributions from FY2024 onward given the projected real value of FY2023 sector grants ($78.99 million). The full period rate of return of 6.7 percent through FY2020 fell short of the 10.0 percent rate that was needed. Such an unlikely result is all the more concerning as this "simple" sustainability estimate relies upon performance during the distribution period at a 5.0 percent real rate of return (roughly a 7.3 percent nominal rate of return) and does not allow for market volatility. In the presence of market volatility, the Graduate School USA has modelled outcomes under the CTF distribution rules. The model results for the FSM indicate a high probability of periodic fiscal shocks, including years in which zero dollars are legally available for distribution. Notably, over the period from FY2024-FY2063, fully 67 percent of cases show one or more years of zero distribution.

Multiple providers of independent analysis point to a need for both administrative and technical or rules-based amendments to the CTF Agreement. No distribution rules

Figure 12: CTF likely to fall short of both Simple Sustainability estimate and SAFER estimate
Compact and FSM Trust Fund projections FY23



would simultaneously allow for (i) protecting the real value of the CTF corpus, (ii) ensuring distributions at or near the real value of the FY2023 grants, and (iii) avoiding year-to-year volatility of distributions. Certain administrative issues have been raised pointing to the language of the CTF Agreement not being amenable to efficient administration when the distributions phase begins. In addition, recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost. A key empirical finding is that once market volatility is accounted for, the size of the CTF would need to be approximately 1.7 times larger than estimates using a simple fixed rate of return with no market volatility. For the FSM, achieving sustainability in the face of volatility implies a CTF value at the end of FY2023 of $2.74 billion. The median expected value of the FSM CTF at the end of FY2023 is $1.25 billion. Of course, making substantial improvements to the terms of the CTF Agreement would require mutual agreement by the original parties, which for the US entails both executive and congressional approval.

Post-Amended Compact Uncertainties

Annual Compact sector operating grants, Compact infrastructure grants, Supplemental Education grants, and disaster assistance are scheduled to expire in FY2024. The loss of approximately $79 million annually of operating and infrastructure grants is targeted to be replaced through funding provided from distributions from the Compact Trust Fund; however, there is considerable uncertainty over the continuation of many other special and Federal programs and services provided to the FSM by the US. In particular, the FSM benefits from the Special Education Grant (SEG), which was cashed out from former Federal programs provided in the original Compact, would expire. Funding is provided through annual Congressional appropriations whose continuation post-FY2023 will end under current law. There are many other US Federal programs whose funding is subject to Congressional authorization, such as, Postal Services, FDIC, NOAA, Pell grants, FAA, and health programs.

After accounting for a sustainable level of distributions from the CTF and other losses in a severe outcome scenario, the FSM would face massive fiscal disruptions. While the shortfall in fully sustainable distributions from the Compact Trust Fund is estimated to be $45 million after FY2023, the range of possible values in the loss of Federal programs may, in a truly severe case, would be an additional $33 million or more (the sum total of SEG, Federal Programs, and Pell grants in FY2018). Combining the reductions in sustainable drawdowns from the CTF and potential loss of Federal programs and services indicates the possibility of a truly severe case outcome of a reduction in grants of $78 million or nearly 20 percent of the pre-COVID-19 GDP of the FSM.

Fortunately, such a result is deemed highly unlikely by informed observers who now anticipate successful, and perhaps even generous, Compact economic assistance renewal terms. The scale of US assistance to the FSM in relation to the size and fragility of the FSM economy begs for a successful outcome of ongoing negotiations for renewed economic assistance under the Compact. The FSM leadership is in a challenging position where they are required to seek positive negotiating results that would allow the FSM to respond favorably to renewal terms; however, the leadership must also prudently prepare for an unlikely, but far less beneficial, outcome that would bring on a period of unwelcome fiscal compression as early as October 2023.

FSM summary economic indicators, FY2010-FY2020

	FY2018		Population	GDP per capita
GDP current prices, $ million	401.9	Chuuk	49,337	2,018
Population	104,286	Kosrae	6,709	3,385
GDP per capita $	3,854	Pohnpei	36,704	6,201
GNI per capita $	3,953	Yap	11,537	4,454
GNDI per capita $	5,818			

FY18 GDP estimates are "interim" until administrative data on business gross revenues becomes available.

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
National accounts											
GDP, at constant prices $ million, FY2004 prices	241.5	250.2	245.8	236.8	231.3	242.3	245.1	251.2	251.3	258.5	
GDP, % growth	2.2	3.6	-1.8	-3.6	-2.3	4.7	1.2	2.5	0.1	2.8	
GDP, % growth (excluding purse-seine fishing boats)	3.5	1.2	-1.7	-2.2	-3.4	2.4	2.7	3.4	0.4	2.1	
GDP series was suspended after FY2019 due to lack of provsion of business gross revenues											
FY2018 and FY2019 GDP estimates are "interim" until administrative data on business gross revenues becomes available.											
Prices (annual percent change)											
Consumer price index	3.6	3.9	6.3	2.1	0.7	0.0	-0.9	0.1	1.4	4.0	0.5
CPI Domestic items	5.7	5.1	9.5	3.6	1.3	0.3	0.1	3.3	4.0	0.5	1.4
CPI Imported items	3.0	3.5	5.3	1.7	0.5	0.0	-1.3	-1.0	0.5	1.4	-1.5
Employment and Wages											
Number of employees	15,841	16,146	15,875	15,588	15,151	15,158	15,467	15,780	15,971	15,816	15,402
% change	4.4	1.9	-1.7	-1.8	-2.8	0.0	2.0	2.0	1.2	-1.0	-2.6
Private sector	7,459	7,762	7,551	7,299	6,967	7,033	7,192	7,342	7,547	7,300	6,709
% change	8.1	4.1	-2.7	-3.3	-4.5	1.0	2.3	2.1	2.8	-3.3	-8.1
Public sector	8,315	8,284	8,220	8,169	8,039	7,962	8,048	8,191	8,239	8,358	8,536
% change	1.3	-0.4	-0.8	-0.6	-1.6	-1.0	1.1	1.8	0.6	1.4	2.1
Average annual wage	7,654	7,663	7,905	7,965	8,056	8,288	8,218	8,389	8,484	8,989	9,429
% change	2.3	0.1	3.1	0.8	1.1	2.9	-0.8	2.1	1.1	5.9	4.9
Private sector	4,867	5,054	5,222	5,170	5,047	5,165	5,241	5,329	5,229	5,627	5,933
% change	3.8	3.8	3.3	-1.0	-2.4	2.3	1.5	1.7	-1.9	7.6	5.4
Public sector	10,132	10,076	10,329	10,423	10,600	10,989	10,844	11,066	11,369	11,816	12,080
% change	3.2	-0.6	2.5	0.9	1.7	3.7	-1.3	2.1	2.7	3.9	2.2
Average annual real wage (less inflation)	5,691	5,486	5,324	5,252	5,274	5,424	5,017	4,898	4,961		
% change	-1.3	-3.6	-3.0	-1.3	0.4	2.8	-7.5	-2.4	1.3		
Government Finance Statistics, $ millions											
Revenue	200.3	201.0	215.2	196.1	206.0	207.9	226.6	282.3	314.6	299.6	
Tax revenue	35.6	37.3	38.0	38.2	60.3	39.0	42.7	64.0	129.5	106.1	
Grants	136.7	136.8	140.6	111.7	88.8	91.1	107.5	130.9	99.4	103.1	
Other revenue	28.0	26.8	36.6	46.1	57.0	77.8	76.4	87.5	85.8	90.3	
Expense	-135.8	-135.7	-142.2	-141.7	-147.9	-153.4	-162.8	-174.9	-183.0	-185.0	
Compensation of employees	-68.0	-68.0	-67.7	-69.1	-69.8	-69.8	-69.8	-73.7	-74.5	-79.0	
Use of goods and services	-54.5	-52.4	-58.8	-53.7	-62.3	-67.8	-75.6	-86.6	-94.9	-90.7	
Other expenses	-13.3	-15.4	-15.7	-18.9	-15.8	-15.8	-17.4	-14.6	-13.5	-15.2	
Net Worth and its changes	-62.4	-64.6	-71.9	-54.4	-58.1	-54.5	-63.7	-107.5	-131.6	-114.6	
Nonfinancial assets	-63.2	-67.1	-70.1	-45.3	-22.6	-21.7	-39.1	-55.0	-32.8	-37.9	
Financial assets	2.3	-4.1	-8.8	-3.2	-30.7	-42.2	-32.0	-84.2	-83.7	-63.8	
Financial liabilities	-1.5	6.6	6.9	-5.9	-4.8	9.5	7.4	31.7	-15.1	-12.9	
Overall fiscal balance	**1.4**	**-1.8**	**2.9**	**9.1**	**35.5**	**32.7**	**24.6**	**52.5**	**98.9**	**76.7**	
In percent of GDP (excl. MRA)											
Revenue	67.8	64.8	66.0	62.3	68.3	66.2	68.9	80.1	90.7	82.4	
Taxes	12.0	12.0	11.6	12.2	20.0	12.4	13.0	18.2	37.3	29.2	
Domestic revenues	46.3	44.1	43.1	35.5	29.4	29.0	32.7	37.1	28.7	28.3	
Grants	9.5	8.7	11.2	14.7	18.9	24.8	23.2	24.8	24.7	24.8	
Expensew	-46.0	-43.7	-43.6	-45.0	-49.0	-48.8	-49.5	-49.6	-52.8	-50.8	
Compensation of Employees	-23.0	-21.9	-20.8	-21.9	-23.1	-22.2	-21.3	-20.9	-21.5	-21.7	
Use of goods and services	-18.5	-16.9	-18.1	-17.0	-20.6	-21.6	-23.0	-24.6	-27.4	-24.9	
Non-Financial Assets	-4.5	-5.0	-4.8	-6.0	-5.2	-5.0	-5.3	-4.1	-3.9	-4.2	
Overall fiscal balance	**-21.1**	**-20.8**	**-22.1**	**-17.3**	**-19.3**	**-17.3**	**-19.4**	**-30.5**	**-38.0**	**-31.5**	

FSM summary economic indicators, FY2010-FY2020 contd.

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Money and Banking ($ million)											
Assets	178.4	190.1	228.1	237.7	270.4	281.1	263.3	283.1	293.3	288.4	313.9
Foreign assets	111.8	124.3	159.5	172.4	199.3	198.9	173.6	192.2	204.8	202.8	226.8
Loans	55.7	55.2	56.8	54.0	60.9	68.9	78.4	77.8	75.8	73.0	75.4
Commercial loans	34.0	33.0	31.5	29.4	33.5	37.8	41.3	40.9	44.2	37.7	42.6
Consumer loans	21.7	22.2	25.3	24.6	27.4	31.1	37.2	36.9	31.6	35.3	32.8
Other assets	10.9	10.6	11.8	11.3	10.2	13.3	11.3	13.0	12.7	12.6	11.7
Liabilities	178.4	190.1	228.1	237.7	270.4	281.1	263.3	283.1	293.3	288.4	313.9
Deposits	154.1	166.2	204.3	213.2	243.9	253.0	234.2	253.3	263.9	258.3	283.6
Capital	24.3	23.8	23.7	24.5	26.5	28.1	29.1	29.8	29.4	30.0	30.1
Loans to deposit ratio, %	19.3	-0.9	2.9	-4.8	12.7	13.1	27.6	26.6	19.9	6.0	-3.9
Balance of Payments $ million											
Trade balance	-128.4	-134.0	-125.4	-128.8	-117.5	-127.9	-110.3	-120.2	-128.5		
Service balance	-45.1	-45.0	-43.4	-37.7	-17.3	-34.1	-40.3	-30.5	8.3		
Primary Income balance	10.6	9.6	15.4	25.5	25.4	59.4	54.7	49.9	10.3		
Secondary Income balance	110.9	109.4	109.1	109.4	128.9	116.7	119.6	138.5	194.5		
Current Account, balance	-52.1	-60.0	-44.4	-31.5	19.5	14.1	23.8	37.7	84.6		
Capital Account, balance	64.2	62.0	68.3	42.2	21.2	30.9	32.4	33.0	19.6		
Financial Account, balance	12.1	2.0	23.9	10.7	40.7	45.0	56.2	70.7	104.2		
International Investment position (IIP), $ million											
Total stocks, net	182.6	185.1	225.3	263.8	302.7	338.5	383.8	466.5	618.2		
Direct investment, net	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.		
Portfolio investment, net	153.7	146.3	151.3	174.3	192.1	213.0	228.0	269.7	397.1		
Other investment, net	26.7	36.6	71.9	85.7	106.8	120.0	150.0	192.4	216.8		
memo: COFA Trust Fund	177.2	198.5	257.3	323.1	380.9	397.3	467.1	564.3	636.2		
External Debt, $ million											
Gross External Debt Total	85.6	88.2	88.4	87.7	89.7	81.1	80.4	80.4	75.7		
External Debt Net of Offsetting Assets	51.9	55.6	56.9	57.3	60.5	56.7	57.1	57.8	54.7		
Gross External Debt as % of GDP (excl. MRA)	29.0	28.4	27.1	27.9	29.7	25.8	24.5	22.8	21.8		
Net External Debt as % of GDP (excl. MRA)	17.6	17.9	17.5	18.2	20.0	18.1	17.4	16.4	15.8		
Debt Service	4.9	5.5	5.6	6.4	7.4	6.7	6.4	6.6	6.5		
Debt Service as % of national government revenues	13.5	14.8	11.8	11.3	8.1	7.4	7.1	5.8	3.6		

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ECONOMIC BRIEF

FSM FY 2021

The FSM Economic Brief is produced annually to provide an independent assessment of the Federated States of Micronesia's economic performance and policy environment, as well as independently verified economic statistics. The FSM Economic Brief summarizes the full FSM Economic Review, which is developed to assist the government of FSM and the US Department of the Interior's Office of Insular Affairs to fulfill their respective reporting requirements under FSM's Compact of Free Association with the United States.

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