ASIAN DEVELOPMENT BANK **RRP: RMI 345040**

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON

PROPOSED LOANS

AND

TECHNICAL ASSISTANCE GRANT

TO THE

REPUBLIC OF THE MARSHALL ISLANDS

FOR THE

FISCAL AND FINANCIAL MANAGEMENT PROGRAM

May 2001

CURRENCY EQUIVALENTS

The currency unit of the Republic of the Marshall Islands is the US dollar.

ABBREVIATIONS

ADB	–	Asian Development Bank
AMI	–	Air Marshall Islands
EPPSO	–	Economic Policy, Planning, and Statistics Office
GAO	–	General Accounting Office
GDP	–	gross domestic product
IMF	–	International Monetary Fund
KADA	–	Kwajalein Atoll Development Authority
MIDA	–	Marshall Islands Development Authority
MIDB	–	Marshall Islands Development Bank
MIITF	–	Marshall Islands Intergenerational Trust Fund
MISSA	–	Marshall Islands Social Security Administration
MOHE	–	Ministry of Health and Environment
MTBF	–	medium-term budget framework
OCR	–	ordinary capital resource
PSE	–	private sector enterprise
PSRP	–	Public Sector Reform Program
RIF	–	reduction in force
RMI	–	Republic of the Marshall Islands
SDR	–	special drawing right
SF	–	special fund
TA	–	technical assistance
TTPI	–	Trust Territory of the Pacific Islands
US	–	United States
VUG	–	vulnerable urban group

NOTE

The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends. For example, 2001 begins on 1 October 2000 and ends on 30 September 2001.

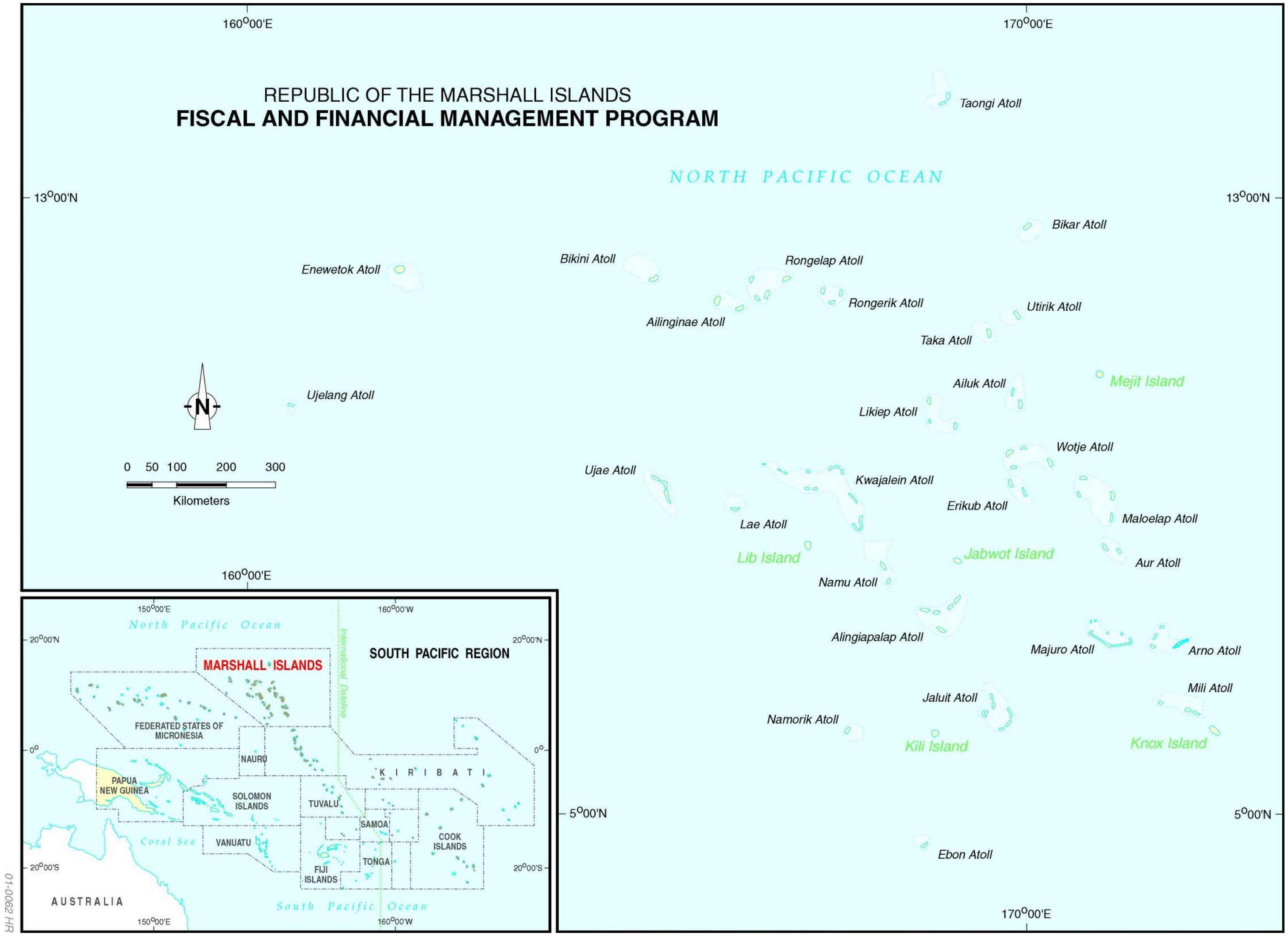
CONTENTS

LOANS AND PROGRAM SUMMARY

Borrower	Republic of the Marshall Islands (RMI)
The Proposal	A Program to support fiscal and financial management
The Program	
Rationale	The Government of the RMI has been undertaking structural adjustments to stimulate economic development and contain budgetary deficits. The Asian Development Bank (ADB) supported public sector reforms under the Public Sector Reform Program (PSRP) loan in 1997. Additional reform initiatives are required to consolidate the gains of the PSRP. The Government is moving on a number of fronts to achieve an economy less dependent on external flows in an environment that promotes good governance, strengthen the financial sector for growth, and improve the policy environment for the private sector. The Government has requested ADB's support for its reform initiatives to undertake far-reaching and necessary changes required to ensure long-term self-reliance, improve public financial management, overcome current financial difficulties, improve the environment for the private sector, and meet the adjustment cost of the Program.
Objectives and Scope	The key objectives of the Program loans are to (i) ensure a sustainable income flow for future generations, (ii) strengthen public sector financial and economic management, (iii) stabilize the fiscal position, (iv) enhance the policy environment for the private sector, and (v) improve the effectiveness of the public service.
Classification	Primary: Sustainable economic growth Thematic: Good governance
Environmental Assessment	Category B
ADB Loan	
Loans Amount and Terms	ADB will provide a loan of $4,000,000 from its ordinary capital resources (OCR) and a loan in various currencies equivalent to SDR 6,320,000 from its Special Funds (SF) resources ($8.0 million equivalent). The OCR loan will have a maturity of 15 years, including a grace period of 3 years, with interest determined in accordance with ADB's pool-based variable lending rate system for US dollar loans and a commitment charge of 0.75 percent per annum. The SF loan will have a repayment period of 24 years including a grace period of 8 years and a 1 percent interest charge during the grace period, and 1.5 percent thereafter.

Program Period and Tranching	The Program period is from June 2001 until May 2004. The loans funds will be released in three tranches. The first tranche of $4.3 million equivalent ($2 million OCR and $2.3 million SF) will be made available after loan effectiveness and upon compliance with first tranche conditions; the second tranche of $5.4 million equivalent ($1.5 million OCR and $3.9 million SF) will be released upon compliance with second tranche conditions; and the remaining balance of $2.3 million equivalent ($.05 million OCR and $1.8 million SF) will be released upon compliance with third tranche conditions.
Executing Agency	The Ministry of Finance will be the Executing Agency for the loan and will have overall responsibility to implement the Program.
Procurement	The proceeds of the loans will be disbursed against a broad range of imports, except for a negative list of items. The proceeds of the loans will only be used to financed items produced and procured in ADB member countries except the ineligible items specified in a negative list. Procurement under the loans will follow normal commercial practice by the private sector, or standard Government procedures for procurement by the public sector, except that goods commonly traded on the international commodity market will be procured in accordance with procedure appropriate to the trade.
Counterpart Funds	Counterpart funds to be generated from the proceeds of the loans will be utilized to finance the costs associated with implementation of the Fiscal and Financial Management Program.
Technical Assistance	Technical assistance in an amount equivalent to $950,000 for (i) fiscal and financial advisory services, (ii) economic strategy advice, and (iii) building capacity for a more efficient public service is proposed together with the Program loan. TA closing date will be co-terminus with loan closing in May 2004.
Risks	The Program has identified four major risks: (i) inadequate political commitment over the next 15 years, (ii) national capacity constraints, (iii) resource constraints arising from dramatic cuts in Compact funding, and (iv) less-than-expected financial returns from the MIITF. While these will remain risks, the Program proposes mitigating measures to manage the risks and minimize the impact on the country's economic stabilization and self-reliance initiatives.

MAP


REPUBLIC OF THE MARSHALL ISLANDS
FISCAL AND FINANCIAL MANAGEMENT PROGRAM
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Ailuk Atoll
Mejit Island
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Wotje Atoll
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Erikub Atoll
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Lae Atoll
Lib Island
Jabwot Island
Aur Atoll
Namu Atoll
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MARSHALL ISLANDS
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FEDERATED STATES OF MICRONESIA
NAURU
KIRIBATI
PAPUA NEW GUINEA
SOLOMON ISLANDS
TUVALU
SAMOA
VANUATU
COOK ISLANDS
FIJI ISLANDS
TONGA
Coral Sea
AUSTRALIA
South Pacific Ocean
01-0062 HR

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on proposed loans to the Republic of the Marshall Islands (RMI) for the Fiscal and Financial Management Program. The Report also describes proposed technical assistance to provide economic, financial, and economic advisory services and specialist inputs, and if the proposed loans are approved by the Board, I, acting under the authority delegated to me by the Board, shall approve the technical assistance.

II. INTRODUCTION

2. The RMI consists of over 1,000 small islands having a total land area of only 181 square kilometers (km^2) dispersed over 2 million km^2 of ocean. The population of about 53,000, currently growing at an estimated rate of 1.5 percent per annum, is concentrated in two main urban centers, Majuro and Ebeye. Like several of the smaller Pacific countries, the RMI is remote from major markets, deficient in both the quality and quantity of land resources, and acutely short of skilled labor, although it does possess potentially rich marine resources built on fish and seabed minerals. The RMI has a dual economy, with a subsistence sector coexisting with a modern urban cash economy. It has limited productive potential, particularly in terms of agricultural potential, while land-based investment opportunities are further constrained by a traditional land tenure system that complicates or precludes secure access to land.

3. After World War II, the United Nations (UN) established the Trust Territory of the Pacific Islands (TTPI), comprising the Marshall Islands, as well as the Caroline Islands (now the FSM) and the Northern Mariana Islands, to be administered by the United States (US). The Marshall Islands became a republic in May 1979, following the approval of a constitution through a national referendum. In 1982, the US and RMI signed a Compact of Free Association (Compact). The Compact came into effect in 1986 when the UN Trusteeship was terminated. The national constitution of 1979 provides for a parliamentary system with legislative, executive, and judiciary branches. The political structure is a blend of the American and British systems of Government. Legislative power is vested in the House of Representatives, the Nitijela. In addition, the traditional Council of Chiefs, or Iroij, acts as a consultative body that may request reconsideration of any bill affecting customary law, particularly as it relates to land tenure.

4. During the Trust period, the US was given permission to use the TTPI for military purposes. A naval base was established on Kwajalein atoll, which was later developed as a missile test site as part of a US global system for interballistic missiles. Since 1947, the base has provided employment for 300-800 Marshallese who received wage equivalent to those paid in the US. In the period up to 1986, a small cadre of Marshallese was educated and employed in Majuro, again at wages equivalent to those in the US.

5. Since the Compact became effective in 1986, the RMI has been receiving considerable economic and technical assistance from the US. While containing specific provisions on the relations between the two Governments in areas such as foreign affairs, immigration, defense, and environmental protection, the Compact revolves principally around (i) economic assistance, both grant and program assistance, with a number of provisions regarding trade and taxation; and (ii) compensatory payments, associated with research, medical, and agricultural/food programs, for the use of the RMI's territory for nuclear tests carried out in the 1940s and 1950s in the four atolls of Bikini, Enewetak, Rongelap, and Utrik, and for continuing US military operations on Kwajalein atoll. Total Compact payments have been declining from 70 percent of gross domestic product (GDP) in the late 1980s to below 50 percent at present. However,

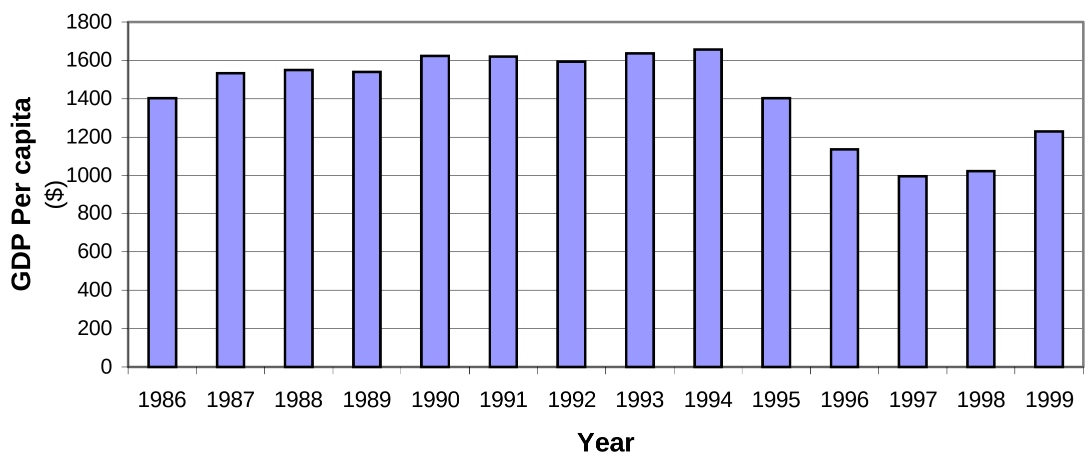
Compact funding is the lynchpin of the economy and effective utilization of these funds remains a key policy issue in the country.

III. THE MACROECONOMIC CONTEXT

A. Recent Economic Performance and Prospects

6. Over the last 15 years, the RMI economy has been largely stagnant. The overall GDP (in 1991 prices) increased by about 17 percent from $53.4 million in 1986 to $62.6 million in 1999. This was, however, not enough to counterbalance the growth rate of population which, despite a large migration to the US, increased by 34 percent over this period. As a result, there was a significant decline in per capita income in the country, from $1,404 (in 1991 constant prices) in 1986 to $1,230 in 1999, a decline of about 12 percent (Figure 1).

Figure 1: Real Gross Domestic Product (GDP) per Capita (1991 Prices)



Source: RMI Office of Planning and Statistics

7. Agriculture and fisheries have traditionally been the mainstay of the economy. But in 1999, the share of agriculture and livestock in GDP was only 4.5 percent, lower than in 1995 (6.7 percent). Production of copra, the main cash crop, declined from 6,815 metric tons (t) in 1986 to 3,348 t in 1999. With an exclusive economic zone of over 2 million km^2, fisheries is considered as the sector with potential for generating economic growth. Fishing accounted for 7.4 percent of GDP in 1999, but a large part of the income was from royalties from fishing done by foreign companies in Marshallese waters. The total fish catch by Japanese and other foreign fishing vessels has been declining, from 12,993 t in 1989 to 2,457 t in 1999.

8. Manufacturing is virtually nonexistent. Processing of copra products runs at a loss and has a negative value-added of 0.2 percent of GDP in 1999. Other manufactured products and handicrafts were only 1.9 percent of GDP in 1999, lower than in 1995 (2.5 percent). While a tourist sector is beginning and has potential for income generation, it is still limited.

9. Electricity, gas and water, and construction are the only part of the goods-producing sector that forms a sizable portion of GDP and has been growing at least slightly (from 12.2 percent of GDP in 1995 to 13.25 percent in 1999).

10. The service sector is the dominant part of the economy, accounting for 71.4 percent of GDP in 1999, marginally up from 69.9 percent in 1995. Public administration generates nearly 5 times as much income as agriculture. The service sector depends on the public sector expenditures, which in turn depend largely on external flows. This underlines the important fact that external flows are vital for the Marshallese economy; without these flows in one form or another, the economy in its present form would collapse.

11. Despite decline in per capita incomes, there has been a marked improvement in the health status in the country over the last 15 years. Infant and child death rates have been considerably reduced: infant deaths from 63 to 37 per 1,000 live births and mortality rates of under 5 from 93 to 48 per 1,000 live births. Life expectancy has increased from 61 in 1988 to 67 in 1999. Family planning is also making progress and the total fertility rate has declined from a very high level of 7.2 in 1988 to 5.7 in 1998. However, informal safety-nets are beginning to fail, family structures are breaking down, and there is evidence of hunger, child neglect,[1] and other symptoms of emerging poverty.

12. There has been progress in education too. The 1999 census reported that as much as 97 percent of the household population of 10 years and older were literate (able to read and write a simple message in any language). Access to elementary and secondary education also increased significantly during the last 10 years. School-age children enrolled in elementary schools increased from 82 percent in 1988 to 84 percent in 1999 and those in secondary schools from 47 percent in 1988 to 69 percent in 1999. The performance of schools and training institutions in RMI is, however, poor. The output standards are below regional parity. A significant number of students are leaving school ill equipped for a productive life, and low skill levels in the labor force deter investment. Major education issues are poor quality of public education, especially on the outer islands, and the relevance of school curricula to the workforce realities in the Marshall Islands.

13. The United Nations Development Programme (UNDP) ranks the Marshall Islands 8th out of 12 Pacific Islands developing countries on both its human development and poverty indices. This lower ranking status reflects the UNDP assessment that one of four of the population is illiterate, almost one child in five is underweight, and almost one household in five does not have access to safe water. The country faces formidable challenges in the form of environmental degradation, accelerated sea-level rise, the legacy of nuclear testing, and localized pollution in several overcrowded islands.

14. Due to relatively easy migration rules to the US, a significant number of Marshallese have been emigrating to the US and the actual growth rate of population during 1988-1999 was only 1.5 percent per year (while the natural rate of increase of population was 3.5 percent per year) and that of the labor force only 2.4 percent per year. However, employment generation in the country over the last 15 years was negligible and employment in the monetized sector in fact declined by about 10 percent during 1988-1999. As a result, unemployment increased from 12.5 percent in 1988 to 30.9 percent in 1999. It is 73.3 percent in the age group 15-19 and 56.6 percent in the age group 20-24.

15. This unemployment situation may constitute a veritable social time bomb in the country.

[1] Development in the 1990s of a brisk market in overseas (mostly US) adoption of Marshallese children—and the promotional role of law firms acting as go-betweens—was a clear sign of growing malaise, especially among the urban unemployed.

As has happened in many other developing countries, such high unemployment can become a source of social problems, including the breakdown of law and order. So far the RMI has had a relatively good record on law and order, but its continuance cannot be taken for granted if the unemployment situation continues to worsen. To avoid such eventuality, the Government must urgently consider ways of increasing employment. Even if the growth of the labor force could be slowed down to 1.5 percent per year (from the current 2.4 percent), there would be a need to create employment for about 10,000 workers between 1999 and 2020, or roughly 500 jobs per year.

Table 1: The Emerging Unemployment Problem in the RMI

Item	1980	1988	1999
A. Working age (15 and over) population	15,294	21,244	28,698
B. Economically active population	7,309	11,488	14,677
C. Employed population	6,598	10,056	10,141
of which: Monetized sector	3,596	7,983	7,221
1. Public	1,809	3,392	3,106
2. Private	1,787	4,591	4,115
D. Unemployment rate (percent)	9.7	12.5	30.9

Source: Office of Planning and Statistics. 2000. *Marshall Islands Statistical Abstract 1998 & 1999*. Majuro.

16. A related development issue is labor productivity and sustainability of wage rates. A minimum wage rate of $1.5/hour was established in 1986 and was increased to $2/hour in January 1995. The Government as the single largest employer maintains this standard, while in the private sector many smaller businesses reportedly pay less than the minimum wage. The Government generally pays higher rates than the private sector for nominally equivalent jobs. Output per person, on the other hand, appears significantly higher in the private sector. This is generally believed to result largely from the greater autonomy enjoyed by managers in the private sector in motivating, disciplining, and rewarding employees, free from political pressure and unhindered by the notion that permanent employment is a right. By regional standards, the RMI's public service pay rates are high, 2-3 times higher than the rates prevailing across most South Pacific island countries, and many times higher than in Southeast Asian countries. The flow-on effect to private sector wage rates and high operating costs, combined with the continued strength of the US dollar, hurts the RMI's competitiveness as a tourism and investment destination.

B. Development Objectives, Strategy, and Plans

17. The inflow of money from the Compact led to major disequilibria in the RMI economy. It lessened pressure for fiscal balance, and encouraged imports and discouraged development of new exports. Support for wage levels that were not in line with levels of productivity kept costs of production higher than they otherwise would be, and worked against the development of new productive activities. These negative factors were aggravated by the Government's practice of borrowing against future Compact receipts. Part of this money has been invested in projects of doubtful quality and with low or negative returns, while an important part has been used to finance budget deficits.

18. A report[2] by the US General Accounting Office (GAO) reviewing the effectiveness of Compact funds in promoting "economic self-sufficiency" of the country came out with some sobering conclusions about the quality of development performance in the country. After an extensive review of the programs and projects financed through Compact funds, it concluded:

> "Compact expenditures to date have led to little improvement in economic development in the RMI. Per capita incomes, when adjusted for inflation, have fallen in the RMI since the beginning of the Compact. Compact funds spent to support general government operations have maintained high government wages and a large level of public employment that has discouraged private sector growth. Compact spending to create and improve infrastructure has not directly contributed to significant economic growth. In addition, Compact funded business ventures have generally failed. Money has been wasted, because the authorities did not conduct cost-benefit or feasibility analyses or plan for local environmental conditions or maintenance needs and were not held accountable for the effective use of funds. The persistent problems we found in project planning, implementation, and monitoring demonstrate a lack of adequate skills and experience in managing projects and large budget funds."

19. The Government of the RMI has been attempting structural adjustments to stimulate economic development and contain budgetary deficit for over half a decade. Under the Public Sector Reform Program (PSRP) loan from ADB in 1997, the Government moved on a number of fronts, including improving the policy environment for the private sector, strengthening the financial sector for growth, and achieving an economy less dependent on external flows. However, with the death of President Amata Kabua, the main champion of reforms, there were some slippages. The new Government which took office in January 2000 is reform-oriented and believes that follow-up actions as well as additional reform initiatives are required. Recent actions taken including meeting targets on staff reduction under PSRP as well as other anticorruption and good governance measures initiated by the Government lend credence to this commitment.

20. The current leadership in the country wants to ensure that serious efforts are made to change the past attitudes and devise a new political consensus for economic self-sufficiency. In an interview with Universal News in Majuro 20 January 2000, President Kessai Note put the problem in the following terms:

> "One of the most important tasks facing all of us in the RMI is to work together to make the Marshall Islands more self-reliant to the extent possible. For many years we have been trained to depend on other countries to provide for our daily basic needs. It is an age-old attitude that needs to be changed.
>
> The US has been generous in the past. However, we both realize that at the end of the 15-year period, the financial assistance provided was not sufficient to make the Marshall Islands a self-supporting country, which was the primary aim of the Compact when we started it. The economic assistance provided under the Compact has come and gone without much change to the level of economic development in the Marshall Islands."

21. It is this clear recognition of the failures of the past and a determination to reverse the past trends that provide the setting to the new development strategy that the Government is in

[2] U.S. General Accounting Office. September, 2000. Foreign Assistance: *US Funds to Micronesian Nations Had Little Impact on Economic Development.* Washington, D.C.

the process of adopting. The Government requested ADB in August 2000 for a follow-up program loan for fiscal and financial sector reforms: to undertake economic and financial planning to implement strategies for long-term financial stability, establish a national trust fund to ensure sustainable financing of the budget and social development activities over the longer term, stabilize its immediate financial position, and continue further reforms in the financial and fiscal sectors.

22. The economic provisions under the Compact between the US and the RMI will be expiring in 2001. Until a new Compact is negotiated, the RMI's economy will be in transition. ADB assistance has been considered essential to help the RMI lay the groundwork for future development and, in particular, take the economy through this transition period expected to last for another 2-3 years until the renegotiated economic provisions of the Compact come into effect. As elaborated in the development policy letter from the President of the RMI (see Appendix 1) and in section V, the Program is designed to achieve sustainable pro-poor growth without continued reliance on external assistance. It is also designed to achieve greater equity and improved quality of life of the people which, in the Pacific context, represents a major poverty reduction initiative.

IV. PUBLIC SECTOR AND FISCAL ISSUES

A. Public Sector

23. The public sector is overwhelmingly dominant in the RMI economy. The national and local governments not only provide an important share of formal employment in the economy, but also own and control a large number of corporations and statutory bodies. While many Government holdings have been corporatized over the years, and subsidies successfully reduced or eliminated in many cases, public sector dominance of the economy remains.

24. Public administration consists of the national civil service under the responsibility of the Public Service Commission, the Marshall Islands Development Authority (MIDA), the Kwajalein Atoll Development Authority (KADA), and 24 local governments. MIDA was established in 1984 as the authority to investigate, develop, and implement social and economic development programs and projects. It was created to coordinate Government actions to the development of public and private businesses and as such, is regarded as the business arm of the Government. The funding source has always been the capital account of Section 211 of the Compact. These funds are now used mainly for debt servicing and MIDA has lost much of its importance. The KADA was set up in 1985 to plan and implement development activities on Kwajalein Atoll, with a view to improving living conditions in Ebeye.

25. The TTPI administration left the RMI with a large, costly, and poorly performing public service, a condition that continued after independence. In 1994 a Presidential Committee looking at public sector reform concluded that the service was overstaffed and inefficient, had many unproductive employees, lacked skilled staff, and showed widespread duplication. Reforms over the past four years have had a major impact, but further improvements are needed.

B. Civil Service

26. The Constitution assigns responsibility for the public service to the Public Service Commission (PSC). The PSC is the employing authority of the public service, charged with its organization, management, efficiency, and economy of the service. Under the Constitution, PSC

members have security of tenure similar to High Court judges, and the PSC is required to act independently, not under direction from the Cabinet or anyone else.

27. The Constitution states that the PSC should take into account “the need to afford reasonable employment opportunities for employment of citizens…” and should act “consistently with government economic and social policy, bearing in mind that the conditions of employment in the public service are a major element in the well-being of the Marshall Islands.” This requirement, effectively in force well before independence, reflects the role of government employment in widely distributing US-provided income within the RMI community.

28. Until 1996, the RMI civil service grew in size and complexity, supported by Compact payments. For many years, growth in the civil service aroused some concern but little action. While funds were available to cover the growing number of civil servants, there was little apparent need for restraint. The total personnel in the public service increased from 1,751 workers in 1988 to a high point of 2,303 by 1995. At that time there were 10 ministries; the Ministry of Education was the largest with 733 employees and the Ministry of Health and Environment had 411 employees (Table 2).

29. By 1995 it was realized that the public service could not continue to expand. This realization was triggered by the fiscal crisis caused by Compact revenues drying up and by the failure of government’s investments from borrowings to yield expected returns. The payroll became increasingly difficult to fund and the Government was forced to address the size and cost of the civil service. The Public Sector Management Improvement Program approved by the Nitijela as part of the PSRP recommended wide-ranging cuts. The Program was successful in reducing the size of the public service, but was less successful in raising the efficiency levels.

30. With the implementation of the reduction-in-force (RIF) program, the public service was reduced by more than a third to 1,484 in July 2000. Table 2 shows how this reduction was achieved and which areas were affected most. The reductions fell unevenly across the service. The social service departments took longer to achieve the proposed cuts as ministries tried to work out how to cope with the staff reductions while maintaining services. In the end, education and police services achieved fewer cuts, while health numbers eventually fell below initially anticipated levels. The notable exception to this was the elimination of the Ministry of Social Services, which involved eliminating the school feeding program in 1996 and retrenching almost 200 employees. The remaining services from this department were transferred to the Ministry of Internal Affairs and Social Welfare.

Table 2: Staff Numbers by Agency, 1995-2000

Ministry/Unit	October 1995	Nitijela Recommended Ceiling	Actual July 2000	% Change Oct 95-Jul 2000
Auditor General	7	5	7	
Cabinet	13	8	8	-38
Chief Secretary's Office	24	19	22	-8
Council of Iroij	4	2	3	-25
Education	733	630	667	-9
Finance	61	52	35	-43
Foreign Affairs	39	32	28	-28
Health and Environment	411	351	343	-17
Environmental Protection Authority	11	11	9	-18
Internal Affairs (& Social Welfare)	32	39	49	+53
Justice	160	139	161	+1
Marshall Islands Marine Resources Authority (MIMRA)	36	31	-	-100
Nitijela	21	18	10	-52
Planning & Statistics	11	9	6	-45
Public Service Commission (PSC)	10	8	4	-60
Resources & Development/Public	180	72	66	-63
Social Services	223			-100
Transport & Communication	6		16	+167
Transport & Communication Shipping Operations	77			-100
Transport & Communication Airport Operations	11		4	-64
Public Defender	7	5	4	-43
Marshall Islands Development Authority	3	2	2	-33
Judiciary Courts	20	17	15	-25
Postal Services	15	13	12	-20
Attorney-General	10	8	11	+10
Regulatory Authority		13		
Others			2	
Vacancies	178			-100
Total	**2,303**	**1,484**	**1,484**	**-36**

Source: Ministry of Finance payroll.

31. The other departments that achieved large reductions were those interfacing with the private sector or involved in providing services that could be supplied by the private sector. The Ministry of Public Works, the Ministry of Transport and Communications, and the Ministry of Resources and Development were all hard hit by the staff cuts. In part, this reflected the Government recognition that the government's role was spread too widely and too thinly to be effective. One of the achievements of the RIF is that it made the Government focus on those services that are important to maintaining its "social contract" with the people, and in so doing cleared the way for the private sector to move into areas previously occupied by the Government. However, the proposition that the private sector will necessarily be a better service provider, particularly where the circumstances make commercial competition unlikely, is not yet proven.

32. The leading case is interisland shipping. With public service withdrawal from providing shipping services, maintenance, and public works, a number of outer islands are suffering

because of hitches in implementing the privately run domestic shipping service. Public works is another problem area. The department was largely dismantled under the RIF as many construction and maintenance jobs were contracted to the private sector, but the Government lacks civil engineering and public works expertise in-house to specify and supervise contracted work. These problems stem not from the inability of the private sector to cope with the work but with the capacity of the public service and the need for the service to recognize its changing role.

C. Fiscal Development and External Position

33. Disciplined fiscal management is a key element in the sound development of the economy. Recent budgetary operations summarized in Table 3 show that despite the public sector reform program launched in the mid-1990s, improvement in the RMI's budgetary situation has not been sustained. Current expenditures have declined from $53.8 million in FY1996 to $50.1 in FY2000; but that was largely due to lower interest payments as the large borrowings of the past were being paid off. Current expenditures minus interest payments actually increased from $46.3 in FY1996 to $48.2 million in FY2000. Payments against wages and salaries declined from $21.4 million in FY1996 to $17.3 million in FY2000 and subsidies to public enterprises from $2.6 million to $1.5 million. However, "other subsidies and transfers" have increased from $4.7 million in FY1996 to $10.3 million in FY2000, which more than compensated for decline in wages and salaries and in subsidies to public enterprises. Taxes as a percentage of current expenditures declined from 36 percent to 32 percent over this period and all revenues as percentage of GDP from 37 percent to 23 percent. The current deficit is estimated to be $11.8 million in FY2000, which will be 12.3 percent of GDP, significantly higher than the level in FY1997 when the PSRP was launched.

34. During FY1999 and FY2000, the Government utilized about $23 million of its financial assets and by the end of FY2000, the usable government financial assets were reduced to $0.2 million, the lowest ever in recent history.

35. The main area of improvement is government debt, which declined from $127.7 million in FY1995 to $60.5 million in FY2000. These debts are expected to be substantially paid off by FY2001 and this will save the country debt service payment of about $20.0 million per year. The future strength of government finances and the income security of future generations will depend on how wisely these savings are utilized in the future.

36. The balance of payments account in the RMI is very much a reflection of the government accounts. The imports of goods and nonfactor services in FY1999/2000 were estimated to be $69.3 million, about 71 percent of GDP, whereas exports of goods and nonfactor services were only $14.9 million, about 15 percent of GDP. The deficit was more than fully met by factor incomes and unrequited transfers (including Compact payments), which were $61.7 million in FY1999/2000. The current account surplus of $7.3 million was not, however, sufficient to meet the net outflow on capital account of $14.7 million, the result was a drawdown of the financial holdings of the national and local governments. The emerging problems on the balance of payments account are a mirror image of the government's budgetary position reviewed above.

Table 3 : Central Government Finances, FY1991-FY2001
($ million)

Item	FY1995	FY1996	FY1997	FY1998	FY1999	FY2000 Budget	FY2000 est	FY2001 Budget
Total revenue and grants	77.7	78.1	68.8	71.5	65.5	62.1	62.1	68.8
Total domestic revenue	34.9	36.0	27.8	24.7	26.7	22.6	22.5	24.6
Taxes	19.5	19.4	18.6	18.7	16.9	15.8	16.1	16.9
Income	9.3	8.5	8.1	7.6	7.6	7.5	8.0	8.5
Gross revenue	3.1	3.9	2.7	2.7	2.5	3.0	3.1	3.2
Imports	6.3	5.7	7.0	7.5	6.2	5.0	3.9	4.8
Other	0.9	1.3	0.8	0.8	0.5	0.3	1.1	0.3
Nontax	15.4	16.6	9.2	6.0	9.8	6.8	6.4	7.7
Fishing rights	2.2	1.6	1.9	1.3	2.3	3.0	3.4	4.4
Fees and charges	2.0	2.8	1.9	0.6	0.6	0.3	0.5	0.3
Investment income	6.2	1.1	0.8	1.6	0.6	0.6	0.3	0.3
Other	5.1	11.2	4.6	2.4	6.3	2.9	2.2	2.8
Grants	42.8	42.1	41.0	46.8	38.8	39.6	39.6	44.1
Of which: current grants	19.4	14.1	18.0	22.9	15.8	15.8	15.8	15.8
Compact	36.4	34.6	30.4	30.9	30.9	30.9	30.9	30.9
Other	6.4	7.5	10.6	15.9	7.9	8.7	8.7	13.2
Total expenditure	109.8	60.1	60.4	56.6	55.3	53.8	57.1	53.8
Current expenditure	66.8	53.8	52.9	51.8	48.4	46.8	50.1	44.1
Wages and salaries	21.9	21.4	18.8	18.0	17.0	17.1	17.3	17.5
Goods and services	18.0	17.5	17.8	21.6	18.8	18.8	19.0	19.1
Interest payments	7.5	7.5	6.8	5.4	4.3	2.3	1.9	0.9
Subsidies to public enterprises	6.0	2.6-	2.1	2.6	1.4	1.5	1.5	1.5
Other subsidies and transfers	3.7	4.7	5.4	3.6	6.1	7.0	10.3	4.9
RIF payment[a]	0.0	0.0	2.1	0.6	0.8	0.1	0.1	0.1
Capital expenditure	43.0	6.4	7.5	4.8	6.9	7.0	7.0	9.7
Current balance	-12.4	-3.7	-7.1	-4.2	-5.9	-8.4	-11.8	-3.6
Overall balance	-32.1	17.9	8.4	14.9	10.2	8.4	5.1	15.0
Financing								
Net government borrowing	-12.2	-12.4	-7.3	-11.0	-27.9	-13.4	-11.6	-16.0
Gross borrowing	4.1	4.1	10.7	7.9	15.0	5.3	7.1	9.0
Principal repayment	16.2	16.5	17.9	19.0	42.8	18.7	18.7	25.0
Asset sales	0.0	0.0	0.0	0.0	0.0	5.0	1.3	2.5
Use of government financial assets	44.3	-5.6		-3.8	17.7	0.1	5.3	-1.6
				(percent of GDP)				
Revenue and grants		80.5	74.6	74.7	67.3	64.7	64.7	69.6
Revenue	33.2	37.1	30.2	25.8	27.4	23.5	23.4	24.9
Grants	40.7	43.4	44.5	48.9	39.9	41.2	41.3	44.7
Expenditure	104.4	62.0	65.5	59.2	56.8	56.0	59.5	54.4
Current	63.5	55.4	57.4	54.2	49.7	48.7	52.2	44.6
Capital	40.9	6.6	8.1	5.0	7.1	7.3	7.3	9.8
Current balance	-11.8	-3.8	-7.8	-4.4	-6.1	-8.8	-12.3	-3.7
Overall balance	-30.5	18.5	9.1	15.5	10.5	8.7	5.3	15.2
				($ million)				
Memorandum items:								
Government fund balance	30.0	41.5	42.5	47.0	29.3	29.2	23.9	25.5
Usable government financial assets[b]	18.2	9.9	9.3	12.4	4.8	4.7	0.2	1.8
Outstanding government debt	127.7	115.3	108.1	97.0	70.1	58.7	60.5	44.5
Stock of arrears	1.6	1.4	0.9	1.2	1.0	0.9	1.7	1.7

[a] Early retirement and separation program (reduction in force) financed by an ADB loan.
[b] Cash and cash equivalents that are not reserved for specific uses.
Source: Ministry of Finance, RMI, and IMF.

D. Government Expenditure

1. The Short-Term Budgetary Crunch

37. The long-term development debacle in the country has been compounded by a short-term budgetary crunch, which threatens to disrupt the normal operations of the government. "Usable government financial assets" in Table 3 which show cash and cash equivalents that are not reserved for specific uses, declined from $12.4 million in FY1998 to virtually zero at the end of FY2000. As a result, the government is encountering serious difficulties in meeting its payroll, replenishing needed supplies (hospitals have no supply of basic medicine for the last three months) and funding education expenses. The Government is considering suspension of copra buying as there is no money to pay subsidies or even process copra for inventory. This will spell disaster for the outer island economies, which depend largely on copra income. A significant increase in poverty and hardship is likely.

38. It is important to note that the "overall balance" in Table 3 is not a good indicator of the resource position of the country. For example, for FY2000 the estimated surplus in overall balance of $5.3 million is more than fully offset by net outflow on debt of $11.6 million. The deficit of $6.3 million had to be covered by sale of assets and, more importantly, by drawing down on financial balances resulting in near exhaustion of transaction balances.

2. Causes of the Budgetary Crunch

39. This sudden depletion of government financial balances is due to some unanticipated external shocks and not to Government profligacy. The main factors contributing to the budgetary crunch are noted below.

a. Cuts in Import Duty

40. Prior to the national elections in early 1999, the previous Government reduced the basic import duty rate from 12 percent to 5 percent of import values. It put RMI import duties below the regional levels. Due to the less than fully competitive situation among importers, the benefits of the duty cuts were not fully passed on to consumers. It did not bring about quantitative growth in imports. The Government lost revenues to the tune of $3 million during FY2000 and about $1 million in the first four months of FY2001.

b. Health Costs

41. Over the years, the cost of referrals in health services was paid to US companies on the basis of 360 days payment period. Starting in 2000, there was a change in the method of payments to these service providers and the payment period was reduced to 30 days. Since the RMI relies heavily on service providers in the US, this change resulted in large additional payments by the Government in FY2000 and FY2001. As shown in Table 4, the Government had to pay an additional $2.7 million in subsidies to the health fund; even then the fund had a deficit of $1.1 million in FY2000. For FY2001, unless the Government provides additional subsidy, the deficits of the fund will amount to $3.65 million.

42. The poor management of the medical referral system has led to an accumulated claim on the Government's general fund by Marshall Islands Social Security Administration (MISSA) of about $3.7 million for deferred payments. This is the result of poor coordination between the Ministry of Health and Environment, which approves referrals, and MISSA, which acts as the

paying agent. This burden of deferred payments continues without the necessary revenues to cover costs. This was compounded by the recent reduction of employers' and employees' health fund contributions from 3.5 percent to 2.5 percent. The situation is aggravated by the inadequate on-island health care that necessitates sending people overseas even for minor medical problems. The rate at which this liability grows is increasing and jeopardizes the Government's already desperate fiscal position and the delivery of health services.

Table 4: Basic Health Fund
($ million)

Item	FY1997	FY1998	FY1999	FY2000	FY2001 (est.)
A. Revenues	1.98	2.40	1.85	4.92	2.07
1. Employer contributions	1.98	2.40	1.81	2.22	2.07
2. Government subsidies and other receipts	0.0	0.0	0.03	2.70	0.0
B. Expenditures	4.08	3.18	3.39	6.01	5.72
1. Off-island medical claims	2.92	2.11	2.19	4.30	3.81
2. Travel and others	1.16	1.07	1.20	1.71	1.92
Surplus/Deficit	(2.10)	(0.78)	(1.55)	(1.10)	(3.65)

Source: Marshall Islands Social Security Administration, RMI.

c. Undelivered Funds from Asset Sales

43. In the budget for FY2000, a provision was made for receipt of $5 million from the sale of an aircraft by Air Marshall Islands (AMI). The sale was made and AMI received the payment of $5 million. However, the management of AMI claimed that it was short of funds for urgent maintenance work and returned only $1.75 million to the Government's budget. The issue is under consideration by the board of AMI. In the meantime, the Government is faced with a liquidity problem.

d. Copra Subsidy

44. The government-owned copra processing authority is heavily subsidized through the government's budget. Copra is bought at an artificially high price with the Government meeting the difference between commercial price and the supported price. This subsidy is used to inject cash into the mainly subsistence outer-island economies. The action of the previous Government to raise the buying price to 15 cents/lb (6.8 cents/kg) prior to the 1999 election was seen as politically motivated. The increase in price had little impact on the Government's fiscal position at that time because of the lack of inter-island shipping services. With recent improvements in shipping services, the impact on the Government's budget has been severe. Even though the price has been cut from 15 cents/lb to 9 cents/lb (4.1 cents/kg), the total subsidy in FY2001 is expected to reach $2.0 million, more than double what was originally budgeted.

E. Government Objectives and Strategy

45. The Government has been requesting financial assistance from ADB since August 2000 and also trying to raise funds from commercial sources, with little success. In the absence of help from commercial sources, the Government has been forced to borrow from Marshall

Islands Development Bank (MIDB) and to dip into funds set aside for specific purposes. The Government wants to repay MIDB and correct these irregularities by using the funds made available from its program loan. The Government also proposes to start a process of long term policy reforms that can reverse the current downward trend in income and employment generation in the country and initiate a process of sustainable and self-reliant development over the long-term. Such fundamental changes will need a sustained long-term effort. Support of the Government at this hour of need is appropriate and will enable the RMI to undertake major reforms that had been difficult in the past.

F. External Assistance to the Public Sector

1. Asian Development Bank

46. ADB has provided nine loans totaling $59.1 million since the RMI joined ADB in April 1990. The Ebeye Health and Infrastructure Project is being implemented while the Skills Training and Vocational Education Project just started. Both projects include significant elements of sector reforms as well as national capacity building. TA grants totaling $14.53 million for 37 TA projects have been provided as of March 2001; 29 projects have been completed.

2. International Monetary Fund/United Nations Development Programme

47. The International Monetary Fund (IMF) carries out its annual Article IV consultations and has provided TA in the past for studies leading to recommendations on improvements of the fiscal and taxation issues. The IMF is a full and active member of the Consultative Group for the RMI, and is in full support of the proposed Fiscal and Financial Management Program (FFMP) loan. UNDP support has been concentrated on public sector management improvement, training, and small enterprise development.

3. United States

48. Since the Compact became effective in 1986, the RMI has received considerable economic and technical assistance from the US, supplemented by federal grants and additional appropriations by the US Congress. As noted in paras. 3-5, the US is the dominant source of assistance to the RMI.

4. Others

49. Japan’s assistance primarily for infrastructure amounts to around $2 million annually. Recently, Japan rehabilitated all roads in Majuro. Japan is also providing funding for schools and hospitals. In 2000, Taipei,China, provided about $12 million in project funding including $3 million in budget support.

5. Compact Negotiation: Status/Outcome

50. The Compact renegotiation is expected to begin in May 2001 after the RMI has presented its forward-looking strategy and confirmed the economic reform and policy direction it intends to take. The economic policy and reform action will be underpinned by the policy matrix and conditionalities under the proposed program loan. The renegotiation may take place in 18-24 months but must reach some conclusion by October 2003. Under the current Compact, there are provisions for a two-year transition period after expiration pending renegotiation. The

Government will invoke the two-year transitory provision during which the level of Compact funding will be at the average of the past 15 years. This will mean that over the next two years the RMI will receive an amount estimated at $3 million-4 million higher than the current level of Compact support.

51. While it is not prudent to speculate on the outcome of the negotiations, a few clear signals from the US side indicate that: (i) in all likelihood this will be the last time economic provisions of the Compact will be negotiated; (ii) use of Compact funds will be restricted, tied to specific sectors (mostly social) and largely project specific; (iii) for the first time there will be conditionalities similar to those of ADB in the use and disbursement of funds; (iv) the US is looking for an "exit strategy" and finds the ADB initiated trust fund concept acceptable in principle and a viable way for the RMI to attain self-reliance; (v) overall Compact funding is likely to decline, but the US remains concerned about continued economic stability and would like to avoid shocks or a sharp decline in per capita GDP; (vi) funding decline will be partly compensated by separate allocation for placement into the trust fund; and (vii) the level of Compact funding and extent of "nonearmarked funding" (which allows the RMI flexibility to prioritize its own macroeconomic needs) will depend on the Government's strategy and extent of reforms undertaken, especially in improving public sector financial management.

52. The US side believes that, without proper systems and accountability in public financial management, the development and economic growth objectives of Compact funds will again not be met and that funds will not reach the sectors or those who need them the most. Compact negotiations have been in close consultation with ADB and ADB has been requested to take the lead during the two-year transitory period. In summary, the Compact will most likely be renewed for another 15 years at probably 10-20 percent lower than the current level; there will be conditionalities and less "nonearmarked" funding and trust funds will be an integral part of the Compact negotiation. Other provisions such as immigration, and access to federal grant and programs will continue as part of the security relations between the two countries.

G. ADB's Operations and Strategies in the Sector

53. On 30 January 1997, ADB approved Loan 1513-RMI(SF): *Public Sector Reform Program* (PSRP). The main objectives were to (i) stabilize the Government's finances in the short term through a combination of revenue increase and expenditure reduction measures, (ii) ensure the long-term structural stability of Government finances and sustainable efficiency gains, and (iii) improve the environment for private sector activities. The counterpart funds were to (i) compensate employees retrenched from the civil service, (ii) liquidate the high-interest debt of AMI, and (iii) establish the Financial Reserve Trust Fund.[3]

54. Important achievements made under the PSRP include the following:

(i) reducing by 36 percent the Government payroll from 2,303 in November 1995 to under 1,500 employees in June 2000;

(ii) reducing ministries in the public service from 10 to 9;

(iii) freezing civil service wages from March 1996;

(iv) eliminating direct subsidies to AMI and reducing its most debilitating commercial

[3] Currently, Marshall Islands Intergenerational Trust Fund (MIITF).

debt with improved management;

(v) streamlining the company registration process by removing the approval process from the Cabinet and vesting it in a Registrar of Corporations;

(vi) streamlining approval of licenses for foreign investment, removing the task from the Cabinet and vesting it in a Registrar of Foreign Corporations under the new Foreign Investment Business Legislation;

(vii) establishing the Marshall Islands Intergenerational Trust Fund (MIITF) to provide an additional source of revenue for the Government's budget;

(viii) providing a social safety net for retrenched Government employees through a compensation package comprising a lump sum and monthly maintenance payments; and

(ix) privatizing domestic shipping services (which although experiencing problems, is a policy the government is keen to pursue).

55. Several problems were also identified in implementing the PSRP.

(i) Consultation with the community about the need or shape of the PSRP was adequate. The Program was initiated by then President Amata Kabua. After his death, no "champions" of reform rose within the administration, generating the perception that outsiders were imposing the reforms.

(ii) Reducing subsidies to Government enterprises produced mixed results. Direct subsidies to AMI were eliminated, but indirect subsidies continued by condoning debts. After initially falling, subsidies to Tobolar Copra Processing Plant Ltd., the copra processing authority, have returned to prereform program levels. On the plus side, the Majuro Electricity Corporation has not received an operational subsidy for a number of years.

(iii) The reform program achieved its aim of stabilizing government finances in the short run. The structural problems remain. The institutional mechanisms to ensure rational and well-informed decisions do not exist. Lack of budgeting and financial management skills in the civil service compounds the institutional weakness of the Ministry of Finance (MOF).

56. The most important lessons learned from this process were as follows.

(i) In designing reforms, the time for implementing them and their political implications must be estimated realistically.

(ii) Institutional mechanisms, particularly for financial management, need to be stressed in the process as specific fiscal and economic policy measures can be overturned if the institutional mechanisms to consolidate these policies are not in place.

(iii) Without effective financial management and control systems in the dominant public sector, limited success can be achieved.

(iv) Civil service downsizing needs to be complemented by specific measures to increase the efficiency of the remaining civil service staff.

(v) Reform measures need to be fully discussed beforehand to instill both understanding and a sense of ownership before they are implemented.

V. THE PROGRAM

A. Rationale

57. In January 2000 a new reform-minded Government was elected in the RMI with H.E. Kessai Note as President. The new Government inherited a difficult fiscal position with rising expenditures and stagnant revenues. Increased spending and tax reductions shortly before the November 1999 elections were compounded by optimistic revenue forecasts and led to a substantial current account deficit of $5.9 million in FY1999. The full impact of these changes was felt in FY2000, the election year, and resulted in a $11.8 million deficit.

58. The Government recognizes that many current problems are linked to deficiencies in public financial management. Public financial management has suffered from years of neglect and is in need of major reform to improve budgeting, monitoring of, and accountability for public funds. Fiscal policy is further constrained by an absence of reserves and a narrow revenue base. Long-term revenue prospects remain heavily reliant on continued prospects for renegotiations of economic assistance provisions under the Compact. Future reforms should focus on raising public service productivity levels, while keeping a lid on the numbers of staff in the service. The Government recognizes that there is a window of opportunity to lock in important reforms over the next year or two and build a sustainable future by prudent use of financial resources.

59. The proposed assistance comes at an opportune time in that it coincides with the negotiations of the economic provisions of the Compact with the US. Establishing improved financial and economic management systems now will underpin the use of future assistance and set a platform for sustainable fiscal policy. The establishment of the MIITF is the cornerstone of the reforms, modified from the successful models developed elsewhere in the region. However, stable fiscal policy and strong financial management are needed to make this model successful.

60. The Government is moving to address these problems by seeking to improve its financial management, broadening its tax base and strengthening the MIITF, which will eventually replace Compact revenues in the long term. Complementing these moves, ADB is assisting the administration in preparing the Meto2000 economic report and development strategy. The Meto2000 resulted from wide consultation with the community to determine appropriate development policies so as to assist the Government’s negotiations with the US over the renewal of the economic provisions of the Compact. The Government has conducted a National Economic and Social Summit to seek the views of the community on future development prospects and policies to which Meto2000 will be a major input.

B. Objectives and Scope

61. The Government and ADB recognize the opportunity presented by the renegotiation of the Compact in ensuring long-term economic sustainability of the RMI by ensuring prudent use of future Compact assistance. The proposed ADB assistance, while stabilizing the immediate

fiscal situation, aims primarily at longer term issues of improving overall financial management in the RMI. The specific objectives of the financial assistance are to (i) ensure a sustainable income flow for future generations, (ii) strengthen public sector financial and economic management, (iii) stabilize the fiscal position, (iv) enhance the policy environment for private sector development to maximize the benefits from future Compact assistance, and (v) increase the effectiveness of the public service.

62. The time-bound policies to be implemented under the Program are described in the policy matrix in Appendix 2. The Government has confirmed the general direction of the Program in a development policy letter attached as Appendix 1.

C. Policy Framework and Actions

1. Ensure a Sustainable Income Flow for Future Generations

63. Small Pacific island states such as the RMI have limited ability to maintain steady revenue streams indefinitely so as to fund all the services normally demanded in an island nation. A trust fund established in a number of island states has been a successful model to ensure the sustainability of Government finances. The view is that a trust fund can be built up over time through external contributions or windfall gains, with the real earnings of the fund being available to finance structural budget deficits. The key to sustainability of these funds is ensuring that their capital is maintained in real value. Both Kiribati and Tuvalu, two countries similar to the RMI in many ways, have successfully adopted such a model. They have large trust funds established and invested with professional fund managers with strong governance structures to ensure the integrity of the funds. The funds have established a platform for both countries' long-term development.

64. Seeing the success of these countries, the RMI established the MIITF through legislation. The Government has expressed its desire to build up balances in the MIITF by using proceeds from the renegotiation of the economic provisions of the Compact. To do this the Government intends to develop more stringent operational guidelines to revise the MIITF legislation to more strongly protect the capital of the fund and strengthen its governance procedures. Specifically, the implementing guidelines and regulation related to MIITF legislation will ensure that:

(i) the capital of the MIITF is maintained in real terms;

(ii) an independent Advisory Committee will be appointed to provide independent reports to the Board of Directors of MIITF on fiscal policy, economic and social conditions within the Marshall Islands, and management issues of the MIITF;

(iii) the Advisory Committee reports will be made available to the Nitijela;

(iv) the Board of Directors will appoint on a competitive bidding process a professional investment consultant to report to the Board of Directors on the performance of the fund managers;

(v) the Board of Directors or the professional investment consultant will appoint one or more reputable international fund managers to manage the MIITF;

(vi) annual audited accounts for the MIITF by an independent auditor will be published within 6 months of the end of the MIITF's financial year; and

(vii) an annual report prepared by the Board of Directors, including the audited annual accounts, will be made available to the Nitijela.

65. In addition, the Government will set aside the vast majority of the funds available from the Compact with the long-term goal of building the MIITF to a level where its returns will ultimately replace Compact assistance. Strengthening the MIITF and its continued funding by the Government is the cornerstone of this program loan. Based on some conservative assumptions about investment earnings, a fund in the region of $500 million dollars (in 2000 prices) will be needed to replace a significant part of the Compact assistance and maintain standards of living in the RMI.

66. The Government will guarantee that in operating the MIITF, the following conditions will apply.

(i) The amounts indicated below will be deposited in the MIITF:

(a) the whole of any incremental gain from the Compact receipts as well as 70 percent in the first year and 60 percent in the second year of the nonearmarked grant portion of the economic provisions of the Compact available during the two-year extension period after 2001;

(b) 50 percent of the nonearmarked grant portion of receipts under future Compact provisions after 2003; and

(c) the whole of any additional Compact payments for MIITF.

(ii) The capital of the MIITF is not available for expenditure by the Government or any other person.

(iii) the capital of the MIITF may not be used as collateral for Government borrowings;

(iv) The first use of the income of the MIITF will be reinvestment to maintain the real value of the MIITF's capital.

(v) After the MIITF reaches a target figure of $0.5 billion (in 2000 prices), the balance of MIITF's annual income—after maintenance of real capital value and meeting the management costs—will be available to the Government for the Nitijela to appropriate for expenditure through the annual budget process.

2. Strengthen Public Sector Financial and Economic Management

67. The fiscal problems experienced in the RMI can be directly linked to deficiencies in the systems of budgeting and financial management that were unable to handle the huge grants forthcoming from the Compact. The budget format provides little information for scrutiny of the government's expenditure patterns, which limits the Government's ability to make informed decisions about funding priorities and the public's ability to question these spending priorities. The budget is prepared with only the most basic of projections on revenues, expenditures, and information on past expenditure trends. In this environment, fiscal policy decisions often enter

the realm of guesswork and are subject to arbitrary decision making, often to the advantage of vested interests.

a. Improving Financial Management

68. A top priority is to reform and strengthen public financial management. This involves improving the annual budget format to conform to internationally accepted practices, financial control mechanism, accounting system, and the reporting system; and developing a medium-term framework for planning and performance evaluation. The overarching objectives of these reforms will be to ensure transparency, accountability, establishment of input/output relationships, and cost effectiveness of public sector financial management. A summary of these changes are given in Appendix 3. A detailed time-bound action plan clearly indicating the specific steps to achieve the objectives will be prepared jointly by ADB-funded consultants and the PFTAC team. In preparing the time schedule for action, due consideration will be given to available institutional capacity to implement these reforms.

69. Improving fiscal and financial management of the public sector is a critical outcome of the program. Therefore, adequate resources for advisory services have been provided under the loan and supported by the piggybacked TA. The new budget preparation procedures and systems will be undertaken under the guidance and with the support of the budget advisor from PFTAC who has been involved in the preparatory stage of this project.

70. To complement these actions, the Secretary of Finance will issue financial instructions and regulations under the Financial Management Act to govern accounting procedures, competitive tendering, and any procedures needed to safeguard public finances. The Financial Management Act will be reviewed to ensure that the act and related legislation continue to meet the needs of the Government. The incorporation of the desired reforms in legislation will reduce the risk of reversal by future administrations.

b. Improving Corporate Governance

71. The financial relationships between the Government and its public sector enterprises (PSEs) have in the past contributed to the poor economic performance of the RMI. Placing these relationships on a solid and sustainable basis is an important factor in managing the Government's financial situation. This was demonstrated by the problems experienced as a result of losses experienced by AMI in the 1990s which directly impacted on the Government's budget. The current problems in MISSA are another example. It is important to make these financial relationships as transparent as possible to avoid financial problems and also to examine whether the relationship is appropriate or whether other models can be used.

72. To overcome existing and potential problems, the Government is committed to completely review the corporate governance of its PSEs. An important part of this review will assess where PSEs merit subsidies, recommend how corporate governance can improve the outcomes delivered by these institutions, and also identify measures to strengthen financial planning, management, and reporting for improved delivery. The review will recommend a plan and timetable of reductions in subsidies to minimize the impact on the Government's finances.

c. The Economic Policy, Planning and Statistics Office, and the National Policy Coordinating Committee

73. During Cabinet deliberations, ministers often do not benefit from analysis of the economic impact of proposals, especially the impact on the Government's budgetary situation.

The Office of Planning and Statistics (OPS) has this role spelled out in the legislation that established it. In reality, however, OPS has not been able to fulfil its mandate due to factors of location, capacity, its statistical focus, and lack of demand for its services as a policy advisory body.

74. To overcome this deficiency, the Government intends to establish the Economic Policy, Planning and Statistics Office (EPPSO). In creating EPPSO, the Government wishes to draw on existing resources, such as those in OPS, MOF, and other policy offices within the Government, rather than set up a new and separate institution. Using existing resources will help ensure the staffing and institutionalization of EPPSO. Short-term TA from ADB and other sources could be a supplement, especially when EPPSO needs to benefit from specialist inputs.

75. EPPSO will act as the secretariat for a newly established National Policy Coordinating Committee (NPCC) with membership drawn from the senior levels of the civil service but also benefiting from the Chairmanship and representation drawn from the Cabinet. The NPCC will evaluate policy proposals going to the Cabinet, with analysis provided by EPPSO. The NPCC will consider issues from formulating the budget to policy and project requests coming from ministries. To avoid duplication of effort, the NPCC will assume the responsibility of existing committees such as the Budget Coordinating Committee and the Loans Committee. To ensure the effectiveness of EPPSO and the NPCC, EPPSO will be responsible to the Office of the President and will be located within the Cabinet Office. Appendix 4 gives more details of the operation and structure of the EPPSO and NPCC.

3. Stabilize the Fiscal Position

76. The difficult financial position is threatening basic government. Immediate action is needed to stabilize the Government’s fiscal position and this involves improving revenue collection and containing expenditures.

77. On the revenue side, the Government’s main sources of funds are foreign grants. However, most of these funds are earmarked for specific purposes. Discretionary revenue is drawn from a narrow base, which needs to be broadened. In recent times, the tax regime has been the subject of several reform proposals. However, changes in the tax regime are strongly opposed by various sections of the community. Much of this opposition stems from the government’s limited enforcement capacity. Lack of enforcement means that many businesses are avoiding paying their share of tax and that leads to justifiable resistance to tax increases as these will unfairly penalize the existing taxpayers.

78. The Government proposes to strengthen the tax collection division with more trained staff (including the use of private agencies) to collect arrears, check evasion, and to properly enforce existing laws. While improving tax collection, the Government also intends to review and possibly reverse the decision made to reduce the import duties from 12 percent to 5 percent in early 1999. It is proposed that this rate be increased to at least 8 percent by October 2001 and additional reforms be made based on a detailed review of the national and local tax regimes.

79. While these are immediate actions, the Government is aware of other problems that will take longer to overcome. The Government is aware of anomalies in parts of the tax system. For example, by regional and international standards personal income tax is high for the lowest-paid wage earners and low for the middle and upper income brackets. The gross revenue tax is simple in concept and theoretically easy to administer, but it is paid on gross output value at

each stage in (produce/process chain sale), producing a cascading effect of tax being paid on tax. The gross revenue tax takes no account of enterprise profitability – as a good business tax should – and is reportedly subject to widespread evasion and undercollection.

80. The overall tax picture is further fragmented by the wide taxing powers of local governments. Anomalies are created by uncoordinated taxing actions at local level, potentially negating the fiscal intentions of the national Government and compounding the problems of the taxpayer. Statutory and administrative action is needed to integrate national and local taxation into a single scheme that, for example, limits levels of local tax, allows offsets against national tax liabilities, and is simple for the taxpayer to operate. The introduction of a value-added tax was proposed as part of an earlier comprehensive review of taxation in 1996. The idea met resistance from the commercial sector, and the overall tax reform plan was abandoned as national elections approached.

81. The Government intends to correct the anomalies in the tax system, especially the regressive nature of the regime, but feels that it is not ready for immediate action. With help from the accompanying TA project, the Government will review the tax system to look at anomalies and make recommendations leading to improved efficiency and fairness of the regime while broadening and deepening the Government's tax base.

82. On the expenditure side, the Government is working to control various components of the general fund budget. Although significant progress was made during the PSRP, pressure is now building to increase public sector employment and expand government services. To contain expenditures, the Government will

(i) maintain the freeze on salaries of public servants, elected officials, and contract workers for at least two years – FY2002 and FY2003 – or until the review of public service salaries is completed and implemented;

(ii) enforce a cap of 5 percent on general fund expenditure growth starting from a baseline amount of $29.5 million for FY2001, excluding certain one-time expenditures and payment of prior-year liabilities;

(iii) increase employee and employer contributions to the MISSA health fund back to 3.5 percent by legislation;

(iv) limit to $4.0 million overseas referral costs for FY2002 on an accrual basis and further reduce it in FY2003 to match revenue from the Basic Health Care Fund, estimated at $2.8 million;

(v) increase funding for on-island health care in FY2002 to at least $2.8 million to be funded entirely from the Health Care Revenue Facility;

(vi) cap subsidy to health expenditures at $1.2 million per year in FY2002;

(vii) eliminate all subsidies by FY2003, excluding the copra subsidy; and

(viii) review the copra subsidy and its possible replacement with alternative mechanisms for income transfer to less advantaged outer islands.

4. Enhance the Policy Environment for the Private Sector

83. Recent government reforms have improved the policy environment for the private sector. The new administration has legislated improvements in company registration and foreign investment procedures. Despite the improvements, significant impediments to investment and private sector development still need to be addressed.

84. Land access is the most prominent of these impediments. The Government has drafted legislation that will establish a land registration authority where landowners interested in registering their land for investment purposes can voluntarily register their land after the integrity of the title is verified. An added advantage of the system is that leases will subsequently be independent of title in cases where inheritance of land is disputed. Such disputes will not affect already existing leases. The review of the tax system (para. 81) is also aimed at strengthening the incentives in the taxation regime.

85. The role of the MIDB will also be investigated to reorient its efforts to a more business advisory role: from direct lending to assisting businesses to access credit from commercial banks, since direct lending has been subject to significant political interference. Complementing this change will be measures to ensure that appropriate microcredit schemes are established to give credit access to small businesses, women, youth, and other sectors of the community normally denied access to credit. Finally, MIDB will renew its efforts to recover as much nonperforming debt as possible.

5. Increase the Effectiveness of the Public Service

86. A large and inefficient public service has historically limited the ability of the Government to deliver services. The service has been seen as a way of distributing the wealth forthcoming from the Compact rather than from the executive arm of Government. The Constitution of the RMI even backs this perception. Recent reforms have managed to reduce the size of the public service to manageable levels and changed perceptions about the role of the service. Nevertheless, there is still strong pressure inside and outside of Government to increase recruitment to solve the service delivery problems, although experience indicates additional personnel will have little effect.

87. Reducing the civil service has eliminated many underperforming staff, but there is still much inefficiency. A key improvement to the service will be matching the staff with skills to specific jobs and retraining so that the Government can redeploy staff between areas of the civil service rather than recruit new staff. Better qualifications in the professional areas will need to be linked more closely to the Government’s training and scholarship policy to ensure that skills shortages can be overcome. The review will look closely at salary and wage levels in the public service. A key aspect of improving the public service is the need to pay wages commensurate with productivity levels, ample anecdotal evidence suggests that wage levels far exceed productivity levels. High wage levels in the public service also make it difficult for the private sector to attract and retain skilled staff.

88. A review of the service will look at a range of issues. The focus of the reforms will be better management of human resources, including redeployment and retraining, appropriateness of pay scales, conditions of public service, and appropriate delegation of authority. Linkage will be established between financial and human resource inputs and outputs (delivery and service levels) for each ministry. Additional resources to carry out the program for improving the effectiveness of the public sector will be sought from other donors such as the US

and Australia. Component for specialist inputs under the program loan may also be used.

89. As the government moves to contract out more services, the nature of the public service changes from direct service delivery to contract management. To provide for the new skills needed to cope with this change, the government will conduct courses to train administrators in how to manage and enforce contracts to ensure that the government gets best value for money. Contracting-out arrangements in the Government have not delivered the benefits expected mainly due to the inability of the public service to enforce and regulate contracts, given that the role is new and unfamiliar. As mentioned in para. 60, the government will improve financial management and budget preparation skills. Where the government is still in the business of directly providing services to the community, the relevant staff will be trained in all aspects of customer service. The Government will also investigate the possibility of establishing a cadre of civil servants that will enter the service based on the results of competitive examinations.

D. Poverty and Governance Issues

1. Poverty

90. There are aspects of the loan that address all three pillars of ADB's poverty reduction strategy: pro-poor economic growth, equitable social development, and good governance.

91. The serious deterioration in the Government of RMI's fiscal situation has led to a compounding effect on the poor in the RMI. Measures in the loan are designed to address two issues that are causing some hardship among the poor. The first is the Government's current inability to buy copra due to fiscal constraints. This is causing hardship in the poorer outer islands where copra sales are an important part of household cash incomes. Copra prices are subsidized by the Government, and Government purchase of this product is a form of redistributing income to the poor.

92. Second, the arrears associated with poor management of the medical referral system has led to large claims on the Government. Current outstanding claims estimated at $3.7 million have been deferred. The effect of these outstanding claims has been a rundown of operating revenue in the Ministry of Health, with a resulting decline in delivery of health services. Funds from the loan will ensure that payments on the copra and health referral backlog can be addressed. In the case of copra, the measures will be pro-poor and underpin growth opportunities in the outer island economies. The health measures will result in improved, more equitable access to services for poorer Marshallese in the medium term. The issues are further discussed in paras. 42 and 119.

93. There are measures in the loan to address the management of the public sector. Public sector wages have been much higher than those in the private sector. As a result, a disproportionate share of Government fiscal resources is spent on wages, while operational expenditure experience a shortfall. Redressing this imbalance will be an important aspect of the loan, and will result in long-term benefits to the wider Marshallese community. By ensuring more resources are available for long-term productive investment, these measures are likely to result in sustainable economic growth.

94. In addition to managing of the public sector, there are measures in the loan to address management of the financial sector. Medium-term expenditure planning processes will be introduced, with output-oriented budgeting, performance measurements, and linkages to the medium-term development plan. In addition, there will be financial control measures to ensure

that expenditure decisions are made in an environment of transparency and accountability and that succeeding administrations will find such decisions difficult to reverse. Recognizing that transparency, accountability, and predictability are vital aspects of ADB's policy on good governance, these measures are expected to result in significant improvements to governance, and as such, can be regarded as pro-poor in nature. A poverty impact assessment is in Appendix 5.

2. Governance

95. Good governance is the cornerstone of any economy. In its absence, an economy will not function effectively or efficiently, its potential for growth will be stifled, and equity of distribution will be compromised. The people that suffer most will be the poor and underprivileged who do not have the power or influence to capture a fair share of the nation's income.

96. Since independence, the RMI has had a history of poor governance. This culminated in the profligate use of the funds provided by the US under the first Compact of Free Association. While a few families based in Majuro managed to become wealthy, many others, particularly those on some of the outer islands, received little if any benefit. The problem has now been recognized and ADB, among others, is attempting to help the RMI Government to address poverty issues in the outer islands. But for any project to succeed and for scarce resources to reach the poorest, fundamental changes in public sector financial management are required to improve efficiency in the use of limited funding. Transparency, equitable distribution, and special consideration for the needs of the poor are critical.

97. Once again, ADB is in a dilemma. While the situation calls for support, past experience has been disappointing. However, there are real grounds for hope that the situation has changed. If the needs of the new government are ignored, the reformers will in effect be penalized for the actions of their predecessors. At the same time, a lot of poor people will be condemned to increasing poverty with little hope of improvement.

VI. THE PROPOSED LOANS

A. Amount of the Loans and Source of Funds

98. The proposed loans total $12.0 million equivalent from the ordinary capital resources (OCR) as well as special funds (SF) resources. The OCR loan amount will be $4,000,000 and the SF loan SDR 6,320,000 ($8.0 million equivalent). OCR funding has been provided for purposes that are likely to result in cost savings and/or help fiscal balance. SF sources have been proposed for the adjustment costs for improving social indicators, promoting trust funds, strengthening the financial management system, initiating good governance, and building capacity as well as implementing the program.

99. The Program is designed to achieve long-term sustainability and short-term fiscal stability. As such, the size of the loan was based on the proposed costs of adjustments and reforms as follows.

(i) The allocation for MIITF supports the trust fund and provides additional impetus to the Government to use trust funds as an additional source of income and for long-term self-reliance. The MIITF is a major objective of the Program loan (estimated at $2.0 million).

(ii) Payment of health arrears not only relieves pressure on the Government's financial situation, it also addresses an urgent social need. As explained in paragraph 41, the Government must clear arrears in overseas referral payments to be able to refer patients for secondary and tertiary care currently not available on the island. Several critically ill patients cannot be sent abroad as the Government has been unable to generate adequate resources to meet the sudden requirement for health payments (estimated at $3.5 million).

(iii) With the adverse fiscal situation arising from the cutback in import duties and the economic downturn, the Government has been obliged to secure a short-term commercial facility at less than favorable terms and interest rates and temporarily uses funds mandated for other uses. By retiring the high-cost commercial loan, the Government's financial situation will be stabilized over the next 2-3 years (estimated at $2.5 million).

(iv) The fiscal balance support will be provided over 18 months to give the Government time to make the necessary adjustments in its revenues and expenditure. The fiscal situation is likely to be difficult in the context of external shock arising from the economic downturn as well as fuel and other price increases. On the revenue side, the Government intends to increase import duties within FY2001, but the impact will be realized only in FY2002/2003 (estimated at $1.5 million).

(v) Costs for improving the accounting system and implementing improved tax collection and enforcement which are aimed at better fiscal management and improve Government ability to more effectively utilize external resources (estimated at $1.5 million).

(vi) Financing of specialist inputs, Compact renegotiation costs, and program implementation costs directly relate to furthering the objectives of the program and ensuring that the reforms are achieved (estimated at $1.0 million).

100. Given the structure of the RMI economy, assessment of the ability to pay ADB's loan funded from the OCR was based on the extent of net available nonearmarked funds from the economic provisions under the Compact agreement. Currently the nonearmarked portion of Compact funds pays the RMI's bond obligations. These bond obligations will be fully paid by October 2001. Nonearmarked Compact funds will then be available to the RMI to meet discretionary expenditures. If the economic provisions are not renegotiated by the end of 2001, a provision of the Compact allows for an automatic 2-year extension at a funding level that is the average of the past 15 years. Consequently, it is likely that the RMI will receive a higher amount for 2002 and 2003, pending renewal of the economic provisions of the Compact. Subsequently, when the affected provisions are renegotiated (most probable outcome), a certain level of nonearmarked funds are expected to continue to be available to the RMI. In projecting the extent of nonearmarked funds, a 10-20 percent drop was estimated starting 2004 and followed by a 10 percent step-down every five years. Such estimate is merely for the sake of projections and does not in any way reflect negotiating positions or the final outcome of the Compact renegotiations. These estimates are premised on indications that discretionary funds under the Compact are likely to be reduced as the economic provisions are made project/program specific. It is also assumed that the Government intends to set aside 50-60 percent of the nonearmarked funds for the MIITF for purposes of achieving long-term self-reliance. The projected loan repayment schedule (Appendix 6) shows that the RMI will be able to meet its

OCR obligations based on the preceding assumptions.

101. Considering the above, it is proposed that a $4.0 million loan be provided on OCR terms to fund components that are expected to generate direct savings. The SF loan of $8.0 million will be primarily utilized for meeting implementation costs in the areas relating to the health sector; capacity building for improved economic management, in particular for improved governance in the financial and fiscal sectors; and for creating sustainable development to serve future generations. A logical framework for the Program is in Appendix 7.

B. Interest, Maturity, and Implementation Period

102. The Borrower will be the RMI. The OCR loan will have a maturity of 15 years, including a grace period of 3 years, with interest determined in accordance with ADB's pool-based variable lending rate system for US dollar loans, a front-end fee of 1.0 percent, and commitment charge of 0.75 percent per annum. The SF loan will have a repayment period of 24 years including a grace period of 8 years and a 1 percent interest charge during the grace period, and 1.5 percent thereafter. The loans are expected to be disbursed over 36 months, from June 2001 to May 2004.

C. Implementation Arrangements

103. MOF will be the Executing Agency for the loan and will have overall responsibility to implement the Program. A program steering committee (PSC) chaired by the Minister of Finance and comprising selected Cabinet members, representative of the Office of the President, and secretaries of key ministries will be established prior to loan effectiveness. The PSC will be responsible for providing high level policy guidance. MOF will be supported by a Program Coordination Unit (PCU) headed by a program coordinator. The PCU staff will include an accountant, supported by consultant inputs financed by the loan and TA grant. The PCU will provide monthly reports on progress on the policy matrix and highlight any proposed changes and actions taken. Reports will also provide an assessment of whether the new setup and arrangements such as EPPSO are working effectively.

D. Procurement

104. The proceeds of the loans will be disbursed against a broad range of imports with the counterpart funds generated to be used to support the costs of program implementation and related adjustment costs. The proceeds of the loans will only be used to finance items produced and procured in ADB member countries except the ineligible items specified in a negative list (Appendix 8). The Borrower will submit with each withdrawal request a certification that the value of total net eligible imports is expected to be equal or greater than the amount of the ADB projected disbursements under the program loan in a given period and that the required withdrawal will be used to finance eligible items procured in accordance with the loan agreement provisions. ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the Borrower's certification. Procurement using loan funds will be based on normal commercial practice by the private sector, except that goods commonly traded on international commodity markets will be procured in accordance with procedures. ADB will continue to ensure that standard public and private sector procurement procedures used in the DMC concerned are adequate from the point of view of competition and efficiency.

E. Consulting Services

105. The Program will require about 30 person-months of international and about 36 person-months domestic consulting services. There will be specialists in (i) tax advisory consultancy, (ii) public financial management, (iii) trust fund administration, (iv) program implementation, and (v) other specialization as agreed upon with ADB. The consultants will be selected and engaged in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants.

F. Disbursement

106. MOF will ensure that funds released under each tranche are utilized for the purpose for which they are designated (Table 5). ADB project administration will monitor the use of funds and require regular disbursement reports. MOF will be required to confirm that payments for health arrears, repayment of MIDB loan, and deposits to MIITF (in accordance with Table 5) have been made against each tranche release.

Table 5: Program Loans Allocation
($ million)

Item	1st Tranche	2nd Tranche	3rd Tranche	Total	OCR	SF
1. Allocation to MIITF	0.0	1.0	1.0	2.0	0.0	2.0
2. Health Arrears	1.5	1.5	0.5	3.5	0.0	3.5
3. Retire High-Cost Debt	1.5	1.0	0.0	2.5	2.5	0.0
4. Fiscal Balance Support	0.5	0.5	0.5	1.5	1.5	0.0
5. Accounting System	0.2	0.4	0.0	0.6	0.0	0.6
6. Revenue Measures	0.3	0.5	0.1	0.9	0.0	0.9
7. Specialist Inputs/PCU	0.3	0.5	0.2	1.0	0.0	1.0
Total	**4.3**	**5.4**	**2.3**	**12.0**	**4.0**	**8.0**

MIITF = Marshal Islands Intergenerational Trust Fund; OCR = ordinary capital resources; PCU = Program Coordination Unit; SF = special fund.

107. Items 5, 6, and 7 involve use of counterpart funds for specific use throughout the program period. Funds corresponding to these items must be placed in a separate account to ensure timely availability. Arrangements will be made between MOF and ADB project administration for proper accounting and monitoring of expenditures from such accounts.

G. Counterpart Funds

108. Counterpart funds to be generated from the proceeds of the loans will be utilized to finance the costs associated with implementing the Program and will be utilized as follows :

(i) allocation to MIITF (estimated at $2.0 million SF);
(ii) health sector payments arising from change in credit terms of health service providers and deferred past due obligations (estimated at $3.5 million SF);
(iii) retirement of portions of high-cost short-term commercial debt incurred to meet fiscal deficit in FY2000 (estimated at $2.5 million OCR);
(iv) fiscal balance support to meet additional expenditures and/or revenue shortfalls in FY2001 and FY2002 (estimated at $1.5 million OCR);
(v) adjustment costs associated with required changes in the financial accounting

system to make it more responsive to proposed improvements in public financial management to support stronger control, accountability, and better governance (estimated at $600,000 SF);

(vi) costs to improve tax collection and enforce tax and customs duties (estimated at $900,000 SF); and

(vii) financing specialist inputs to improve public financial management, supervise establishment and operation of a trust fund, support Compact renegotiation, and other needs to support program implementation (estimated at $1,000,000 SF).

H. Monitoring and Tranching

109. ADB will periodically review program implementation and will closely monitor its progress and impact on the performance targets. The Government will keep ADB informed of the outcome of policy discussions with other development agencies and their implications for program implementation.

110. In addition to quarterly progress reports, the Government will submit a program completion report to ADB within three months of the loan closing date. This report will evaluate the implementation of the policy measures during the program period, and further reforms and assistance needed in the medium term.

111. The loans funds will be released in three tranches. The first – $4.3 million equivalent – will be made available after loan effectiveness and upon compliance with first-tranche conditions (Appendix 9). The second tranche – $5.4 million equivalent – will be disbursed upon compliance with second-tranche conditions approximately 9-12 months after loan effectiveness. The remaining balance – $2.3 million equivalent – will be released after fulfillment of third-tranche conditions. Table 6 shows the distribution of OCR/SF funds to be released against each tranche.

Table 6: Program Loans Tranche Releases
($ million)

Item	1st Tranche	2nd Tranche	3rd Tranche	Total
Ordinary Capital Resources Loan	2.0	1.5	0.5	4.0
Special Funds Loan	2.3	3.9	1.8	8.0
Total	**4.3**	**5.4**	**2.3**	**12.0**

112. The tranche amounts are consistent with the extent of reforms undertaken. The bulk of the loans will be disbursed after major second-tranche conditions are met. A third tranche ensures continued engagement and monitoring of reforms required under the policy matrix.

VII. TECHNICAL ASSISTANCE

113. Over the years, the capacity for economic management in the country has improved. A cadre of young Marshallese has world-class training in economic and business management and older Marshallese have been getting on-the-job experience in economic management since independence. However, the development program currently envisaged by the Government

requires high-level expertise, not all of which is currently available in the country. TA funding will be required to mobilize that expatriate expertise. The Government has classified the required inputs into two categories: (i) those that will generate revenues for the government over the short, medium, or long term; and (ii) those that will be of a general developmental character. The Government has requested that the activities in the first category be funded from the SF component of the Program loan and those in the second category by TA grants from ADB.

114. ADB will provide on a grant basis from the ADB-funded TA program a TA for (i) fiscal and financial advisory services, (ii) economic strategy advice, and (iii) building capacity for a more efficient public service. The TA will fund the services of economic and financial advisers and support the PCU with consultant inputs to ensure compliance with the policy matrix, and undertake benefit monitoring and effective program implementation. The second part of the TA will provide economic management advisory support to the EPPSO for activities mentioned in the policy matrix, and the third component will assist the Government to develop in-house competencies and capacity for public sector management. TA closing date will be co-terminus with loan closing in May 2004. TA details are in Appendix 10.

VIII. PROGRAM BENEFITS AND RISKS

A. Program Benefits

115. The most strategic contribution of the Program will be over the long term. Without the type of reforms envisaged under the Program, development performance over the next 15 years may not differ from that of the preceding 15 years, namely, increasing unemployment and continued decline in per capita incomes. It also means that at the end of the next Compact agreement, reduced foreign inflows will result in sharp economic decline in the RMI.

116. With the successful implementation of reforms, the country's developmental performance will experience a turnaround. With the MIITF fund of about $ 0.5 billion (in 2000 prices) to be reached in 15 years, the country will have gained financial strength to sustain its performance even if Compact funding is substantially reduced. If the program objectives are realized, at the end of 15 years balances in the country's trust fund can generate in perpetuity a flow of annual incomes of about $25 million (in 2000 prices). With better management of its resources, the country can stop the decline in per capita incomes. And with programs for employment generation, it can avoid the baseline scenario of increasing unemployment and poverty.

117. The primary gain in the medium term will be the improved budgetary situation and developmental effectiveness of the public sector. Improvement in the budgetary situation will come primarily from two program components: (i) increased import duty and efficient collection of revenue in general, and (ii) cap on growth of current government expenditures. At the end of four years, the current account deficit in the budget is expected to be substantially eliminated.

118. The immediate short-term objective of the Program is to prevent a budgetary crisis. The economic structure of the country depends heavily on the Government sector. As noted in para. 37, the financial assets of the Government will be nearly exhausted if present trends continue. The Government may not be able to pay wages and salaries to its employees. With an extended family system, a typical Government worker often supports more than eight family members, some of whom do not have any other means of subsistence. The social disruption will have an immediate adverse effect on the creditworthiness and credibility of the Government. The Program loan will help avoid such a crisis.

119. The overall design of the program will not have any obvious direct impact on the poor as a separate group. The policy actions and conditions are designed to have broad effects across the whole community; however, in the design of the conditions, special consideration has been given to the possible impact on the poor to avoid negative impacts. For example, in minimizing subsidies on copra, consideration will be given to alternative means of maintaining incomes of copra growers in outer islands. Changes in the income tax system proposed under the Program will benefit lower income groups and mitigate the impact of increase in import duties and other taxes. Positive benefits will primarily be in the form of an improved “enabling environment” for productive investment. The improved governance, as a result of changes in public sector and financial management, is expected to encourage increased levels of investment. This will be further underpinned by improved access to micro-credit for the low income groups. In addition, greater certainty in fiscal outcomes will ensure cuts to essential pro-poor services, such as copra purchases and primary health care are avoided.

B. Risks and Mitigating Measures

120. The main risks in program implementation and the mitigating measures to manage the risks are presented below.

121. **Inadequate Political Commitment**. The most serious risk arises from the possible weakening of political commitment to reforms. This issue becomes particularly important because ADB’s earlier program loan to the RMI (PSRP) had only partial success. After discussion during the Appraisal Mission, it was concluded that there are at least three reasons why the chances of success are better this time.

(i) One key reason for the limited success of the PSRP was that very soon after its inception, it lost the main champion of reform – President Amata Kabua – and the Government that followed was inclined to populist policies to continue in power. The victory in the last elections of the reform-minded Government of President Note gives the new Government a powerful mandate and responsibility for reforms. The new Government has made an explicit commitment to reform of the economy, transparency in government, stringent anticorruption measures, and strict enforcement of the law. It has brought back into the Government several key advisers that had supported the late President Kabua’s reform program. President Note himself has publicly expressed his commitment to reforms and has personally reiterated this commitment to ADB. To mitigate this risk, it is envisaged that the major reform measures will be supported by acts of Parliament, making reversals more difficult. Emphasis is also put on institutional reform in mechanisms and working procedures of MOF and Government in general to maintain the discipline envisaged under the program.

(ii) Both the Government and the public are now worried about the consequences of continuing along the past lines and not introducing structural reforms. The analysis by the US General Accounting Office of the inefficiencies in the use of Compact funds in the past and the publicity surrounding the report have driven home the point that unless reforms are introduced, there will be adverse consequences on the size and flexibility in the use of future Compact funding. There is also widespread fear that the per capita income of the county may decline severely over the long term if reforms are not initiated. Even more importantly, the sharp increase in youth unemployment and emergence of pockets of vagrancy and poverty have instilled fear in the society that without reforms the country may lose its cherished traditions of good law and order and democracy. Intensive consensus building has ensured that not just the Government but various other stakeholders feel a sense of ownership for the Program.

(iii) The Government now sees more clearly the role of multilateral institutions in helping to design and implement needed reforms. The Government sees the policy matrix not as an external imposition, but as a checklist for its own reform program and as an instrument to sustain the political will to implement these reforms. The Government believes that it is politically more feasible and practically more effective to have conditionalities proposed by multilateral institutions than by bilateral agencies. By entering into agreements on tough and credible reforms with ADB, the Government believes it will be able to reduce the need for politically unacceptable conditionalities in Compact negotiations and improve its public sector to levels now being required by US negotiators. The informal support given by US authorities to the program loan and its implicit link to Compact negotiations help to mitigate the risk of slippages on the program of reforms.

122. Despite these mitigating factors, it must be recognized that the extensive changes the program envisages cannot be brought about in the short term. Sustained effort by the Government over a long period and sustained external support for the Program beyond the current loan will be needed. The three-tranche method as well as the conditionalities expected to be required under the new Compact will help sustain the reform initiatives.

123. **National Capacity Constraints**. To enhance the institutional capacity to implement the reforms, skill formation and an associated TA are provided. In addition, ADB's continued support through the Pacific Financial Technical Assistance Centre and projects in health and education sectors will help in implementing the Program. It is also expected that when young US-trained graduates join the Government, the national capacity for sound economic management will improve. Building on the lessons of the past, ADB will make extra efforts to ensure the high quality of experts mobilized under its TA program. In addition, special Compact funding may be set aside for TA in capacity building, allowing funds to be used to finance consultants in line position until counterpart staff are ready to take over.

124. **Resource Constraints.** Another risk is that adequate financial resources will not be available to meet the program needs. In this connection, the most serious risk relates to the outcome of Compact negotiations. If Compact funding for the future is substantially less than the current levels, Government will need to further reduce expenditures and exert greater efforts at resource mobilization. The program loan articulating the Government's determination to use Compact resources more effectively than in the past is itself a factor that can mitigate the risk of substantial reduction in Compact funding.

125. **Less-Than Expected Financial Returns on MIITF.** If the rates of return assumed on the MIITF are not realized, the long-term objective of sustaining income levels even without Compact funding will not be achieved. The rate of return on the MIITF was assumed to be 5 percent. That is a conservative assumption considering the performance of privately managed funds such as pension funds in the US over the long term. To mitigate the risk, an external advisory board will approve investment guidelines and professional fund managers will be hired on a competitive basis.

IX. ASSURANCES

A. Specific Assurances/Tranche Release Conditions

126. The Government has assured ADB that, in addition to the conditions for the second and third tranche releases, as described in Appendix 8, and the standard assurances, (i) the policies adopted and actions taken prior to the date of the Loan Agreements, as described in the development policy letter of the Government dated 8 March 2001 and the policy matrix, will continue in effect for the duration of the program period, and (ii) the Government will adopt and implement the other policies and take the other actions included in the program, as described in the policy matrix.

127. It was also agreed that the Government and ADB will continue their dialogue on problems and constraints encountered during the implementation of the program. The Government has assured that it will keep ADB informed of policy discussions concerning the program undertaken with other international and bilateral agencies (especially the US in relation to the Compact negotiations) as ADB may reasonably request, and will provide ADB with the opportunity to comment on any resulting policy proposals.

B. Conditions of Loans Effectiveness

128. In addition to the standard conditions of loans effectiveness, the establishment of the PSC and the PCU, headed by a program coordinator and staffed with an administrative assistant/accountant will be conditions for the effectiveness of the loans.

X. RECOMMENDATION

129. I am satisfied that the proposed loans would comply with the Articles of Agreement of ADB and recommend that the Board approve:

(i) the loan of $4,000,000 from ADB's ordinary capital resources to the Republic of the Marshall Islands for the Fiscal and Financial Management Program with a term of 15 years, including a grace period of 3 years, and with interest to be determined in accordance with ADB's pool-based variable lending rate system for US dollar loans and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board, and

(ii) the loan in various currencies equivalent to Special Drawing Rights 6,320,000 to the Republic of the Marshall Islands for the Fiscal and Financial Management Program, with a term of 24 years including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period, and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

TADAO CHINO
President

11 May 2001

APPENDIXES

DEVELOPMENT POLICY LETTER

President
REPUBLIC OF THE MARSHALL ISLANDS

08 March 2001

Mr. Tadao Chino
President
Asian Development Bank
Manila, Philippines

Dear President Chino,

RMI: Fiscal and Financial Management Program Loan

On behalf of the Government of the Marshall Islands, I am writing to request the Asian Development Bank to provide a loan of $12 million in support of Fiscal and Financial Management Program (FFMP) that we are in the process of initiating.

As you know, we have been trying to stimulate development and contain fiscal deficit over half a decade. With those objectives in mind we have been in the process of implementing a Public Sector Reform Program (PSRP) since 1995 with technical and financial support from ADB. This program which began with our presentation of a paper to the Consultative Group Meeting in Manila in December 1995 contained the following three main elements:

- Public Sector Reform;
- Taxation Reform; and
- Private Sector Development.

Public Sector Reform

Supported by a program loan from the ADB aimed at reducing the adverse impact of the measures implemented, the public sector reform program was carried out using a Policy Matrix as an instrument of implementation. The two main highlights of this reform were (a) reduction in force (RIF) of the public service and (b) reduction of subsidies to state owned enterprises (SOEs). As agreed under the Policy Matrix, the Government reduced the size of the public service by over 30% from 2303 in October 1995 to 1484 in June 2000. The subsidies to SOEs were reduced from $8.2 million in FY 1995 to $3 million in FY 1996.

Taxation Reform

Several recommendations were made for taxation reform and some of these were carried out. These included a simplification of the import duty schedule, improvement of tax collection by appointing an expatriate Chief of the Division of Taxation and Revenue in the Ministry of Finance and an expatriate Deputy to him and by passing legislation to impose stricter penalties for non-compliance. As a long term measure for achieving fiscal stability, a Marshall Islands Intergenerational Trust Fund (MIITF) was established by legislation in 1999 and $2.5 million from the Bank's program loan was deposited into this fund. In addition, the Marshall Islands Airport Authority, The Marshall Islands Ports Authority have been established by law. Furthermore, the Road Users Trust Fund Act has also been passed.

Private Sector Development

Under ADB's assistance, a Private Sector Unit (PSU) was established in November 1997. The PSU has undertaken a thorough review of all the SOEs of the Marshall Islands and have made a series of recommendations aimed at (a) commercialization and/or privatization of the SOEs and (b) establishing an enabling environment for private sector development. The Government is studying these recommendations with a view to their implementation. Thus far, as a result of these recommendations, the Kwajalein Joint Utilities Resources Inc. (KAJUR) has been brought under a private management company and the company has been operating successfully. In regard to (b) above, the following Act have been passed by Nitijela, our Parliament.

- The Foreign Investment Business License Act which removes the requirement for Cabinet to award foreign investment business licenses;
- The Association Law Amendment Act which eliminates the need for Cabinet approval for ordinary business corporations;
- Banking Act Amendment, which seeks to ensure prevention of money laundering.

In addition, the following Acts are awaiting approval by the Nitijela: the Marshall Islands International Arbitration Act which would ensure that agreements requiring international arbitration are enforced in accordance with international standards; the Resident Workers Protection Amendment Act which simplifies procedures to bring in alien workers into RMI; and, the Development Land Registration Authority Act which facilitates land registration and agreements involving real estate transactions.

There have been some slippages in the PSRP due to unavoidable circumstances arising due the changes in the Government in 1997 and Cabinet reshuffle in 1998. The slippages include the delay in the passage of the above Act, and the delay in the implementation of some of the main reforms proposed in regard to the tax system. The reasons for these slippages were beyond the control of the present Government.

The new Government that took office in January 2000 was concerned about policy slippage under PSRP and the long-term trends in the economy. With the help of ADB, it initiated a process of in-depth examination of the performance of the economy over the last fifteen years and defining a course of navigation over the next fifteen years. The report thus formulated and named METO 2000 has highlighted several inadequacies of our socio-economic performance over the past fifteen years including a declining trend in the per capita income level and an increasing level of unemployment. The current government is determined to reverse these trends.

Over the past year or so of the life of this Government, the main focus has been on the regeneration of growth in the outer islands and thereby reducing unemployment and encouraging reverse internal migration of people from the capital city Majuro to the outer islands to develop the land and fisheries resources. The Government has mobilized resources to improve sea transportation to the outer islands, to generate power, to rehabilitate and improve outer island infrastructure facilities and to improve schools and hospitals. The Government has restored its repair and maintenance program of infrastructure that had tended to be neglected in recent years.

With ADB assistance both the Ministries of Health and Environment, and Education have formulated and started implementing their strategic development plans. The Government has also been able to revive the regular functioning of Marshall Islands Social Security Administrations (MISSA) with the appointment of a new Board of Directors and the completion of its accounts at a level fit for auditing. Important measures have also been taken to improve the financial viability of Tobolar, the copra processing plant. Funds have been allocated to install facilities to further process coconut oil on island into several types of valued-added products such as soaps and cosmetics. A report on the operations of the Tobolar by a Committee of Inquiry appointed by the Cabinet following a Nitijela Resolution is now being finalized for submission to Cabinet.

However, the problem created by the above type of long-term trend has been compounded by short-term economic shocks. The sharp reduction in import duties from 12% to 5% in March 1999 has reduced annual Government revenue by $3-4 million. In addition, the accumulated debt on medical referrals in the past has required the Government to come up with unexpected and unbudgeted expenditures of staggering amounts. For example, in FY 2000 the Government was unexpectedly required to pay $2.9 to meet the cost of past medical referrals to Honolulu. Furthermore, the anticipated $5 million from Air Marshall Islands from the sale of the SAAB 2000 did not materialize. On top of these, the Government had to incur substantial additional expenditures due to the rise in oil prices.

Faced with the twin crises of fall in revenue and rise in expenditures, the Government has drawn up a far-reaching program of policy reforms and capacity building. Drawing upon the lessons of the PSRP, an effort has been made to have in-depth consultations with all stakeholders in the society and draw up a program, which represents not just the views of technocrats in the Government but also of the society at large.

The Government has planned a Second National Economic and Social Summit for March 24-31 this year to discuss the main socio-economic challenges facing our country today including those faced by the Government and to come up with recommendations for a 15-year development strategy. Representatives from all strata of the Marshallese society will take part in this consultative exercise. Six Discussion Papers have been prepared, translated into Marshallese and have been distributed to the participants. These papers which are based on the findings of several reports on RMI economy and society including the METO 2000, the Sustainable Development Report funded by the Forum Secretariat, the IMF Article IV Mission Report, and the ADB funded 15 –Year Health Strategy Plan and the Education Strategy Plan. These six Discussion Papers prepared by the NESSII Planning and Co-ordination Committee with technical assistance from ADB will provide a basis for discussion at the Summit. It is hoped that while taking into consideration the technical inputs from the above reports, plans and the discussion papers, the representatives of the Marshallese society will come up with a national vision for the next fifteen years and strategies and policy recommendations to achieve that vision.

It is anticipated that the consensus emerging at NESSII will identify the following long-term goals for the country.

- Enhanced self-reliance
- Enhanced growth in Gross National Income
- Equitable distribution of income
- Improved public health
- Improved education and human resource skills
- Environmental sustainability

Within the framework of this overall national agenda we have identified five program components for the implementation of which we are seeking ADB assistance. These are:

- Stabilizing the fiscal position of the national Government;
- Strengthening the public sector financial and economic management;
- Ensuring a sustainable income for future generations;
- Improving the effectiveness of the public service; and
- Enhancing the policy environment for private sector development.

The contents of programs in these five areas are as follows.

Stabilizing the fiscal position of the national Government

This objective will be achieved through the following actions aimed respectively at government revenue and government expenditures:

1. Improving the efficiency, equity and reliability of the present tax system;
2. Improving tax collection; and
3. Bringing present import duties to an acceptably higher level.
4. Reducing expenditures on health care mainly through a reduction in off-shore referrals and improving on-shore health care facilities;
4. Maintaining a freeze on the salaries of public service employees; and
1. Further reduction of subsidies.

Strengthening public sector financial and economic management

This objective will be achieved by:

1. establishing clear and robust system of annual and medium term budgeting, financial control, accounting, internal audit, and reporting to Nitijela;
2. Strengthening economic policy advice to the Cabinet and the Government;
3. Improving the effectiveness of capital expenditure projects; and
4. Strengthening the corporate governance of state owned enterprises (SOEs).

Ensuring a sustainable income flow for the future generations

This objective will be achieved through the following actions:

1. Strengthening the governance of the Marshall Islands Intergenerational Fund which has already been established; and
2. Allocating additional funds into the MIITF with a view to attaining a fund balance of $0.5 billion by 2018.

Improving the effectiveness of the Public Service

This objective will be achieved by the following means:

1. Implementing a number of measures to improve the efficiency of the civil service; and
2. Attracting high quality manpower to the civil service.

Enhancing the policy environment for private sector development

This objective will be achieved by following means:

1. Simplifying land leases for collateral purposes;
2. Reducing the incidence of non-performing loans at the Marshall Islands development Bank;
3. Improving access to credit for small and new businesses;
4. Strengthening competition in the private sector; and
5. Simplifying the regulatory environment.

Despite some progress in capacity building over the last decade, there are still major gaps in our institutional capacity for reforms. We will therefore need technical assistance to define more fully the specifics on reforms and implement them effectively. In view of the importance of technical assistance for implementation of this program, we intend to use a substantial part of the requested loan for such TA programs; but we are also requesting ADB Technical Assistance grants for financing some technical assistance activities for which resources are not available to us.

We would like to request ADB technical assistance for the following activities:

1. To review the structure of the Health Fund to balance expenditures with the available revenues while ensuring adequate access to on-island and off-island care to those most in need.

2. Prepare a program for strengthening of the Budget Office in the Ministry of Finance through appropriate staffing and management reform.
3. To strengthen the Office of Planning and Statistics and economic policy advice to the Cabinet.
4. To revise the statutes of the MIITF with necessary changes made to ensure that the objectives of the fund are met.
5. To undertake a review of the public service management systems, pay scales, conditions, redeployment, retraining and delegation of authority.
6. To do a feasibility study for the establishment of a prestigious civil service cadre.
7. To undertake a review of the financial condition and future role of the MIDB.
8. To prepare an action program for strengthening competitive environment in the private sector.

My Government is fully committed to the timely and effective implementation of the FFMP, as set out in the attached Policy Matrix which is an integral part of this letter. We understand that the provision of the requested loan is conditional to satisfactory progress made with the implementation of the FFMP, and that specific conditions for the release of the first, second and third tranches are contained in the attached Policy Matrix.

With best regards.
Yours sincerely,

Kessai H. Note
President

POLICY MATRIX

Overall Objective 1: To Ensure a Sustainable Income Flow for Future Generations

Intermediate Objectives	Specific Policy Actions	Target Date for Completion	Responsibility/ Resource	Monitoring Mechanism
1.1 Strengthen governance of the Marshall Islands Intergenerational Trust Fund (MIITF)	1.1.1 Publish the statutes of the MIITF and/or regulations or guidelines in relation to MIITF to ensure that the objectives as stipulated in para. 64 of the report and recommendation of the president are met.	May 2001 (1st tranche condition)	Cabinet/Ministry of Finance (MOF) (supported by Asian Development Bank (ADB) technical assistance (TA)	The statutes and guidelines of MIITF are published
	1.1.2 The Borrower shall have ensured that (i) the MIITF has become operational, i.e., a board of directors has been appointed, an advisory committee has been appointed, an independent auditor has been appointed, one or more fund managers have been appointed and investment guidelines have been approved; and (ii) the capital of the MIITF cannot be used as collateral for borrowings of the Borrower.	October 2001 (2nd tranche condition)	Cabinet/MOF supported by ADB TA	Proof of appointment of board/fund manager; appropriate change in regulations approved.
	1.1.3 Make fund operational with $1.8 million provided under the ADB Public Sector Reform Program (PSRP) loan and government contribution to the MIITF	August 2001 (2nd tranche condition)	MOF/Cabinet	Proof of appointments and operational reports
1.2 Allocate and mobilize resources for the MIITF to attain $0.5 billion (in 2000 prices) by 2018	1.2.1 In a letter to ADB, the Government pledges that it will deposit into the MIITF the following:	May 2001	Cabinet/Nitijela	Appropriation acts and annual reports of the MIITF

	(i) $2 million as specified under the ADB loan	As tranche funding is released	MOF	Proof of deposit into MIITF
	(ii) 100 percent of the Compact adjustment increase as well as 70 percent in the first and 60 percent in the second year of the nonearmarked grant portion of the economic provisions of the Compact available during the two-year extension period after 2001	Deposits starting October 2001 (2nd tranche condition) Deposits starting October 2002 (3rd tranche condition)	MOF	Quarterly accounts showing the transfers to MIITF to be submitted to Nitijela and ADB
	(iii) The whole of any contribution to the MIITF and 50 percent of any nonearmarked funds from the renegotiated Compact starting in FY 2004	Starting October 2003	MOF	Same as above
	1.2.2 Nitijela enacts a law obliging the Government to deposit funds into MIITF as specified in (i)-(iii).	September 2001 (2nd tranche condition)		Legislation passed by Nitijela

Overall Objective 2: Strengthen public sector financial and economic management

Specific Objective	Specific Policy Actions	Target Date for Completion	Responsibility/ Resource	Monitoring Mechanism
2.1 Establish clear and robust systems of annual and medium-term budgeting, financial control, accounting, internal audit, and reporting to Nitijela as detailed in Appendix 3	2.1.1 Prepare and present FY2002 budget to Nitijela in an improved format, presenting more information on the expenditures by Government institutions, with the exact format to be determined in consultation with the Pacific Financial Technical Assistance Centre (PFTAC) budget adviser, clearly segregating recurrent expenditures, capital expenditures, one-time expenditures and prior-year liabilities	September 2001 (2nd tranche condition)	MOF/Budget Coordinating Committee/ Cabinet/PFTAC	Budget documentation presented to Nitijela

	2.1.2	Assess the possibility of introducing medium-term budget framework (MTBF) concepts into the budget. Agree to key results and a time-bound plan.	September 2002	MOF/Budget Coordinating Committee/ Cabinet	Budget documentation presented to Nitijela; proof of budget formulation in accordance with MTBF.
	2.1.3	Budget formulated to progressively move towards multi-year budget	September 2002	MOF/Budget Coordinating Committee/ Cabinet	Budget documentation presented to Nitijela include multi-year information
	2.1.4	Cabinet ruling promulgated to all ministries, departments, agencies, Nitijela, and the public, that requests for supplementary appropriations will not be entertained by MOF except for genuinely urgent and unforeseen circumstances	May 2001	MOF and Cabinet	Cabinet minutes
	2.1.5	Prepare and issue financial instructions, on the authority of the Minister, under the Financial Management Act covering matters such as accounting procedures, financial control, and reporting with inputs from ADB/PFTAC	July 2001	MOF	Publication and circulation of financial instructions
	2.1.6	Prepare a program for strengthening of MOF through appropriate staffing, management reform, and technical infrastructure to be able to implement the new budgeting, accounting, and control and reporting system	May 2001 for report	MOF (ADB TA funded)	Report from the finance minister on the strengthened MOF Budget Office
	2.1.7	Prepare regular quarterly reports evaluating progress on new accounting/budgeting/ reports/control system and showing evidence that the Government's budget and accounting system has been overhauled to guarantee meaningful reporting	December 2001	MOF (funding from loan component)	Evidence of the new accounting system being in place Quarterly reports by PCU

2.2 Strengthen economic policy advice available to the Cabinet and Government	2.2.1	Issue instructions to establish in the Office of the Chief Secretary. The Economic Policy, Planning and Statistics Office (EPPSO), which will absorb the existing Office of Planning and Statistics (OPS) so that it can effectively deliver economic policy advice and program/policy evaluation results to the National Policy Coordinating Committee (NPCC) (see 2.2.3)	May 2001 (1st tranche condition)	Office of the President / Office of the Chief Secretary (ADB-TA funded)	Report from the chief secretary of the new strengthened EPPSO
	2.2.2	Amend OPS legislation to strengthen economic policy advice to the government and to serve effectively as the secretariat to NPCC	September 2001		
	2.2.3	Establish NPCC with representation from 3 Cabinet members with terms of reference and membership to include chief secretary, all ministerial secretaries, and selected government officers	May 2001	Office of the President/Office of the Chief Secretary	Cabinet minutes appointing the NPCC
	2.2.4	Prepare and present to the Nitijela a 3-year economic policy statement in format and with the exact content to be determined on consultation with ADB	July 2001	EPPSO	Cabinet minutes
2.3 Improve the effectiveness of capital expenditure projects in the public sector	2.3.1	Publish a project appraisal manual and issue a circular from the office of the President directing the use of the capital project evaluation procedures in all projects above $250,000	October 2001	Office of the President (Funding from the SF loan component)	Project evaluation manual published and reports on implementation progress
	2.3.2	Publish rules and regulations on competitive bidding procedures to be followed for all public projects and for all procurements above $100,000	October 2001	Office of the President assisted by ADB (Funding from the SF loan component)	Rules and regulations on competitive bidding published and implemented

	2.3.3	Provide MOF a copy of all contracts over $100,000	Ongoing basis	All government ministries and agencies	Confirmation from MOF
2.4 Strengthening corporate governance of public sector enterprises (PSEs)	2.4.1	Undertake and publish a study of the management practices and standards of corporate governance applying in the RMI's PSEs, particularly those relating to economic and financial management and the PSE's financial relationship with the Government. The study will devise criteria to identify areas that deserve subsidies and others where subsidies should be minimized over time.	Report to be done by October 2001	MOF and ADB TA	Publication of report
	2.4.2	Cabinet paper stating that all PSEs and government instrumentalities must provide full disclosure of financial information to MOF. The reports must be filed with MOF prior to the release of any subsidy, transfer payment, or contribution.	October 2002	Cabinet/MOF	Cabinet paper
	2.4.3	Publish an action plan for eliminating or reducing all subsidies, including the copra subsidy, and find alternative and more efficient ways to provide transfer payments to the Outer Islands as necessary to avoid economic dislocation	March 2002	MOF and ADB TA	Budgets and audited financial statements of PSEs
	2.4.4	Publish a code of conduct for PSEs and their management, which would specify standards and rules including, but not limited to, director's conduct, conflict of interest, need for disclosure, accounting standards, etc.	December 2001	Office of the President/ Ministry of Justice/ Resources & Development/ MOF	Rules/standards approved by Cabinet, with penalties or legislative actions for violators

Overall Objective 3: Stabilize the Fiscal Position

Intermediate Objective	Specific Policy Actions		Target Date for Completion	Responsibility/ Resource	Monitoring Mechanism
3.1 Increase government revenues	3.1.1	Undertake a comprehensive review, in consultation with ADB, of the national and local taxation regime and make recommendations based on relevant international comparisons on how to improve the efficiency, equity, and reliability of the system	September 2001	MOF	Publication of review
	3.1.2	Implement recommendations of the taxation review	November 2001	MOF/Cabinet	Passage of revised taxation legislation
	3.1.3	Take credible and verifiable measures satisfactory to ADB to ensure collection of import duties at seaports and airports	May 2001	MOF	
	3.1.4	Issue a circular from the Office of the President giving secretaries of all ministries the mandate to enforce collection of all arrears in government revenues for which they are responsible	June 2001	Office of the President	Copy of circular provided to ADB
	3.1.5	Raise import duties on alcohol and tobacco to at least pre-1999 levels	September 2001 (2nd tranche condition)	MOF	Revised tax legislation and supplementary budget
	3.1.6	Enactment of legislation increasing import duty to not less than 8 percent and increase the tax-free threshold on income tax, by an amount to be determined, to offset the negative effects on low-income earners	September 2001 (2nd tranche condition)	MOF/Nitijela	Budget document approved by Nitijela

	3.1.7	MOF will submit to ADB a letter specifying collection targets against specific taxes each year, based on the revisions of the import duty and tax schedules and provide progress and collection reports	September 2001	MOF/Cabinet/ MOJ	Letter from MOF to ADB
	3.1.8	Prepare a Cabinet paper reorganizing the tax and revenue activities into a separate division, headed by an assistant secretary to improve efficiency and effectiveness and to provide appropriate training and technical support	May 2001 (1st tranch condition)	Cabinet/MOF/ PSC	Cabinet paper Implementation progress reports
	3.1.9	Issue circular from the Office of the President giving the secretary of finance the necessary authority to improve tax collection (including the use of private agencies, administration, and check tax evasion; and the authority to enforce taxes and collect tax arrears.	May 2001	Office of the President	Circular from the Office of the President
3.2 Restrain Government expenditures	3.2.1	Review the structure of the health fund to balance expenditures with available revenues while ensuring adequate access to on-island and off-island care for those most in need. The supplemental health fund will be included in this review alternative funding mechanisms such as user-pay options will be considered.	October 2001	Ministry of Health and Environment (MOHE) (with support from ADB TA)	Completion report
	3.2.2	Pass legislation to increase contribution to health fund back to 3.5 percent	July 2001 (2nd Tranche condition)	MOHE	Legislation

	3.2.3	Overseas referral costs for FY2002 on an accrual basis will be limited to $4.0 million based on the procurement of adequate equipment and staffing at the hospitals.	October 2001	MOHE/Marshall Islands Social Security Administration (MISSA)	Financial report form MOHE/MISSA
	3.2.4	Overseas referral costs will be further reduced in FY2003 to match revenue from the basic health care fund, estimated at $3 million.	October 2002	MOHE/MISSA	Financial Report form MOHE/MISSA
	3.2.5	Increase island health care in FY2002 to at least $2.5 million to be funded entirely from the health care revenue fund	October 2001	MOHE	Annual budget
	3.2.6	Make and promulgate policy decision to cap subsidy to health expenditures at $1.2 million per year for FY2002.	April 2002	MOF	Cabinet decision
	3.2.7	Passage of the FY2002 and FY2003 budget, which maintains freeze of salaries for public servants, elected officials and contract workers during FY2002/03 or until the review of public service is completed.	Budgets for FY2002 (2nd tranche condition) and FY2003 (3rd tranche condition)	Cabinet/MOF	Monitoring to be done every 6 months beginning October 2001
	3.2.8	Budget for FY2002 passed by Nitijela with a maximum 5 percent cap on general fund expenditure growth starting from a baseline amount of $29.3 million for FY2001 excluding certain one-time expenditures and payment of prior year liabilities as mutually agreed with ADB.	September 2001 (2nd tranche condition)	MOF/Cabinet	Budget documents and performance monitoring reports
	3.2.9	Prove actual expenditures for FY 2002 comply with the appropriations for FY2002	November 2002 (3rd tranche condition)	MOF	MOF financial statements

	3.2.10	Budget for FY2003 passed by Nitijela with a maximum 5 percent cap on general fund expenditure growth over the Budget for FY2002. Same as above.	September 2002 (3rd tranche condition)	MOF/Cabinet	Budget documents and performance monitoring reports
	3.2.11	Issue Instruction from the Office of the President that any request for funding outside of the appropriated budget for any government instrumentality or PSE will be reviewed by both MOF and the Budget Coordination Committee prior to submission to the Cabinet for consideration .	May 2001 (1st tranche condition)	Office of the President	Letter from the Office of the President
	3.2.12	Cabinet decision eliminating all subsidies by 2003 and implementing the action plan on subsidy reduction under Objective 2, excluding the copra subsidy	December 2001	MOF (funded by loan)	Confirmation from budget performance reports
	3.2.13	Review the copra subsidy in light of the ongoing Nitijela Commission of Inquiry into the operation of Tobolar with a view to establish a of copra price stabilization fund, alternative mechanisms for income transfer	December 2001	EPPSO	Report form EPPSO

Overall Objective 4: Improve the effectiveness of the public service

Intermediate Objectives	Specific Policy Actions		Target Date for Completion	Responsibility/ Resource	Monitoring Mechanism
4.1 Improve efficiency of civil service	4.1.1	Review public service management systems, pay scales, conditions, redeployment, retraining, appropriate delegation of authority and schemes of service with the goal of sustainability improving the productivity of the public service while containing payroll costs within a prescribed ceiling	June 2002	Cabinet/PSC (supported by ADB TA)	Changes to PSC regulations

	4.1.2	Publish the review, and after consultation with interest groups concerned, implement such recommendations agreed upon	August 2002	Cabinet/PSC	Publication of review Implementation reports
	4.1.3	Establish linkage between inputs (financial and human resources) and outputs (delivery levels, etc.) for each ministry to be used as the basis for preparing departmental budgets	June 2002	EPPSO/ADB TA	Report by ADB TA
4.2 Attract high-quality manpower to civil service	4.2.1	Plan and undertake a series of in-service skill enhancement courses for public officers, including but not limited to budget preparation, control of expenditure, contract management, and customer service	Starting September 2001	MOF/PSC/ ADB TA	Training program and workshops
	4.2.2	Publish a feasibility study for introducing a system of prestigious civil service cadre with entry based on competitive examinations	Report by March 2002	Cabinet (supported by ADB TA)	Report

Overall Objective 5: Enhance the Policy Environment for the Private Sector

Intermediate Objective	Specific Policy Actions		Target Date for Completion	Responsibility/ Resource	Monitoring Mechanism
5.1 Simplify land lease for collateral purposes	5.1.1	Enactment of Land Registration Authority Act by Nitijela to improve certainty of land ownership and, in conjunction with the Real Property Mortgage Act, to facilitate the use of land as collateral	April 2001 (1st tranche condition)	Nitijela	Land Registration Act passed by Nitijela
5.2 To reduce the incidence of non-performing loans	5.2.1	Review of the financial condition and future role of MIDB with a view to recovering as much nonperforming debt as possible	December 2001	MOF (supported by ADB TA)	Publication of Review
5.3 Improving access to credit for small and new businesses	5.3.1	Redirect MIDB away from direct lending to providing business advisory services with access to commercial bank credit	December 2001	MOF (supported by ADB TA)	MIDB Charter

	5.3.2 MOF will submit to ADB a feasibility study for introducing microcredit mechanisms that can facilitate small loans to lower income groups for productive investments	December 2001	MOF (supported by ADB TA)	Report
5.4 Strengthen competition in the private sector.	5.4.1 Prepare in consultation with ADB an action program for strengthening the competition environment in the private sector and set out an implementation timetable	Report prepared by December 2001	MOF (supported by ADB TA)	

STRENGTHENING PUBLIC SECTOR FINANCIAL MANAGEMENT

1. The Government proposes to make strong and verifiable commitments to strengthening public financial management as a condition of the loans. The following are recommendations of the Government's Task Force on Accountability with inputs from the Pacific Financial Technical Assistance Centre (PFTAC). The aim is to establish clear and robust systems of annual and medium-term budgeting, financial control, accounting, internal audit, and reporting to the Nitijela.

(i) Annual budget document. Detailed estimates are to be presented to the Nitijela in support of the annual (and any other) appropriation bill. The estimates will be publicly available and will show in a clear format:

(a) total estimated revenue, expenditure, and expected overall balance;
(b) proposal to use any estimated surplus or finance any deficit;
(c) expected sources of revenue, with reference to the legislation empowering the collection;
(d) allocation of expenditure to heads, subheads, and items in sufficient detail to show clearly how public moneys are to be spent on which Government policies and programs;
(e) against each head of expenditure, a summary of the policies, programs, and specific performance targets expected to be achieved during the budget year;
(f) comparative revenue and expenditure for the current and previous fiscal years;
(g) statements of opening and closing balances and flows of funds for all public financial assets and liabilities, including trust and special funds, for the last two fiscal years and the budget year; and
(h) statements of external aid programs, balances, proposed disbursements, and commitments.

(ii) Medium-term budget framework (MTBF). The annual budget estimates presented to the Nitijela are to be accompanied by an MTBF. The MTBF will present a four-year statement of the Government budget, by main heads of revenue, expenditure, and financing, organized in accordance with the government finance statistics format. The first year of the framework will be the current year, showing the latest revised estimates. The second year will be the year for which the estimates are being submitted to the Nitijela for appropriation, and the allocations to heads will be as in the estimates. The third and fourth years will show estimated revenues based on current policy, and the allocations of expenditure that would result from implementing of the policies and programs approved by the Cabinet. Allocations will refer to the appropriate passages in the accompanying economic policy statement (EPS).

(iii) Financial control. Provisions are to be put in place to prevent unauthorized expenditure from the general fund and to limit expenditure from trust or special funds to the unexpended balance of each fund. The power of the Government to authorize expenditure in excess of the total appropriation through supplementary appropriation bills will be limited to a specified fraction of the original appropriation, and restricted to urgent and unforeseen circumstances. The power of the minister to move funds within the estimates will likewise be strictly limited and its exercise must be promptly reported to the Nitijela. Significant penalties will be imposed for breach of these rules. Authority delegated to accounting officers will be linked to strict reporting and sub-control requirements. For cash-flow reasons, the minister of finance will retain the power to restrict expenditure. Bank accounts will be consolidated and control/recovery of imprest accounts tightened. The secretary for finance will control use of credit facilities. The Public Accounts Committee of the Nitijela is to be made effective as the principal forum of Government accountability to Parliament.

(iv) Accounting. The accounting system will be overhauled/replaced. The existing system is not efficient, and its output requires costly on-site support by its installer (a foreign contractor). Daily position statements, weekly cash flow analysis and monthly statements of account to the minister are to be established, leading to semiannual statements to the Nitijela comprehensively setting out the Government's financial position. Accounting officers will be required to reconcile their accounting records with the central Government accounts at least monthly.

(v) Reporting. A comprehensive structure of reporting will be put in place, designed to take up minimum time in preparing reports but detecting and requiring explanation for any significant divergences from the budget, and culminating in an annual report to the Nitijela by the secretary for finance (who is the top civil servant in the ministry).

IMPROVING COORDINATION OF ECONOMIC POLICY

A. Establishment of Economic Policy, Planning and Statistics Office

(i) The Economic Policy, Planning and Statistics Office (EPPSO) will be located in the capitol complex, forming part of the Office of the President. It will absorb the existing Office of International Development Assistance (OIDA) in the Ministry of Finance (MOF) and the Office of Planning and Statistics (OPS) in the Chief Secretary's Department.

(ii) The head of EPPSO will be a senior Marshallese official with a strong background in economic affairs and government administration, proven management and team leadership qualities, and good understanding of the interaction of political, economic, and social factors in sound policy making.

(iii) The staff of EPPSO will comprise Marshallese nationals with appropriate professional and technical skills in economic and social analysis and statistics, supplemented as and when required by external technical assistance in training and short-term advisory positions.

(iv) The functions of EPPSO will include the following:

(a) provide advice on general economic policy, including periodic review of overall national development goals and strategies, to the National Policy Coordinating Committee (NPCC) (item b) and, through NPCC, the Cabinet;

(b) give technical training, advice, and assistance to ministries, departments, and agencies in identifying, specifying, and preparing sector and project plans, programs, and funding submissions;

(c) liaise with MOF in budget preparation and assistance in evaluating and assessing the draft budget prepared by MOF;

(d) prepare quarterly monitoring reports on budgets and major projects and programs for submission to NPCC (item b);

(e) prepare, in consultation with MOF, the annual (three-year rolling) economic policy statement (EPS);

(f) conduct economic and social studies, reviews, and assessments as required;

(g) coordinate, point-of-contact functions and conduct negotiations with overseas sources and lending institutions on programs and projects of assistance to the Republic of the Marshall Islands (RMI);

(h) collect, prepare, and publish economic and social statistics on the RMI;

(i) participate in regional and international statistical cooperation; and exchange of statistical data; and

(j) provide a permanent secretariat and administrative support services to the Policy Coordinating Committee and such other committees, as may be required.

B. Establishment of National Policy Coordinating Committee (NPCC)

(i) The NPCC will be established by a Cabinet resolution and will be within the Office of the President.

(ii) The chairman of the NPCC will be the President or a minister designated by the President to take this position. The deputy chairman will be the chief secretary.

(iii) The members of NPCC will be all the secretaries of ministries plus the head of EPPSO, who will also be the executive secretary of NPCC.

(iv) EPPSO acting as the secretariat to the NPCC will provide secretarial and administrative support, records, etc.

(v) The NPCC will

(a) scrutinize the quarterly budget, programs, and major project monitoring reports prepared by EPPSO;

(b) advise the Cabinet on action required as a result of EPPSO's quarterly monitoring reports;

(c) consider draft budget frameworks and guidelines, and proposals to initiate planning of major projects, in preparation for submission to the Cabinet;

(d) review draft annual budgets, medium-term budget frameworks, and economic policy statements before submission to the Cabinet;

(e) consider terms of reference, negotiating briefs, and other preparations for any official discussions or other policy-related contacts and exchanges with aid sources, lending institutions, and existing or potential commercial investors, and recommendations and advice to the Cabinet; and

(f) undertake other functions delegated or assigned to it by the Cabinet.

C. Preparation of annual Economic Policy Statement (EPS)

(i) The EPS will be prepared by EPPSO (item A), approved by the Cabinet, and presented to the Nitijela by the President at the same time as the budget itself and the multi-year budget framework are presented by the minister of finance.

(ii) The EPS will consist of

(a) a statement of the current national goals and development strategies;

(b) a macroeconomic report;

(c) a short-term economic outlook;

(d) a statement of current macroeconomic policies and any changes proposed, with reasons for the proposed change;

(e) a description, by economic sector, of the major projects and programs

i. completed since the last EPS,
ii. currently being undertaken, and
iii. being planned by the Government and public sector corporations, with a summary of their actual or expected investment costs, the expected effect on annual recurrent revenues and expenditures of the Government (the budget effect of the project), and the expected economic or social benefit of the project in terms of current national development goals and strategies;

(f) a summary of the lessons to be drawn from the quarterly monitoring reports of EPPSO for the preceding four quarters, with a statement of action taken and expected to be taken; and

(g) a tabular presentation of investment projects and programs involving the use of public funds (local or external) for the previous year, the year of publication, the following year, and the year after that, showing actual and expected costs and the actual and expected sources of funds, per year and in total.

POVERTY IMPACT ASSESSMENT

A. Introduction

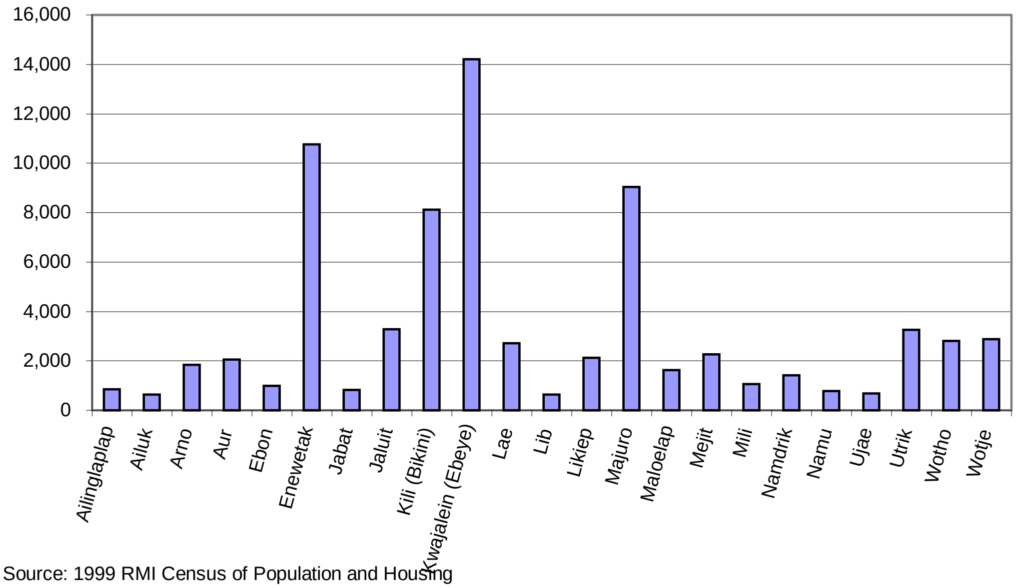
1. The reforms proposed under the Fiscal and Financial Management Program (FFMP) will provide the basis for long-term pro-poor growth in the Republic of the Marshall Islands (RMI) by stabilizing the Government's fiscal position and establishing mechanisms within the financial sector to ensure access to credit for those most in need. The major components of the program include stabilizing the fiscal situation of the RMI Government, strengthening budget management, developing a fiscal stabilization trust fund, improving the effectiveness of the public service, and enhancing the policy environment for the private sector. The strategies proposed in the FFMP reflect the recommendations flowing from the Meto 2000 (TA 3284-RMI) and preliminary findings of the Asian Development Bank's (ADB) work on Poverty Reduction Strategies for the Pacific developing member countries (PDMC) (RETA 5907).

2. In the past, poverty was not seen as a significant issue in the RMI. While inequalities exist between those living in the urban areas and those on the outer islands, the general perception has been that the people of the RMI had a reasonable standard of living. The perception has been perpetuated by the use of the GDP per capita measure to indicate the general welfare in the community. The figures for the RMI indicate that the RMI is relatively better off than other PDMCs, while not allowing for distributional disparities. The perception that the RMI has a reasonable standard of living does not fully accord with statistical data, which shows the RMI ranking 8th among the PDMCs in terms of the United Nations Development Programme's (UNDP) human development index (HDI) and human poverty index (HPI) indices. This must be viewed as a disappointing result, given the level of income enjoyed for much of the past 15 years. Of more immediate concern are the medium- to long-term prospects. If the Compact of Free Association (Compact) is renewed with far less advantageous terms, income levels will plummet and many people are likely to be forced into poverty. The FFMP loan assistance aims to put in place assistance to minimize this possibility.

3. Although there is no agreed upon definition of poverty as it relates to the RMI, evidence from statistical sources and anecdotal evidence indicate huge disparities in cash income available to communities. This is most obvious in the rural-urban dichotomy, with the 1999 census data shown in Figure A1 indicating that households in urban areas have vastly greater incomes than those in rural areas. This situation is also skewed by the existence of pockets of the population who are in receipt of substantial compensation payments as a result of the nuclear testing carried out by the United States (US) after World War II.

4. The RMI is a highly urbanized society with over 65 percent of the population residing in the urban centers of Majuro and Ebeye. Although urban households may have higher incomes in many cases, the number of persons per household will offset this to some extent. Substantially lower income levels in rural areas are partially offset by access to the subsistence safety net. This observation has been reinforced by the physical evidence of distinct pockets of urban poverty in Majuro and Ebeye. This assessment will distinguish between rural and urban impacts.

Figure A1: Median Household Income, 1999



Source: 1999 RMI Census of Population and Housing

5. As discussed in paragraphs 20-24, there will be positive and negative impacts on the poor. However, there are likely to be indirect and long-term effects. Negative effects can be mitigated by careful design of the various policy actions envisaged and also by careful consideration of the terms of reference of the various reviews to be undertaken. Without reform, the effects on the poor could be severe and long-term.

6. No direct mitigating effects are included in the FFMP; however, indirect effects will be evident. Government services will be maintained in key social sectors to mitigate the regressive nature of tax changes. Careful design and protecting transfer payments and subsidies (e.g., copra and outer island shipping) to the less well-off will provide a safety net for the poor.

B. Measuring Impacts of Reform under the FFMP

7. The overall design of the FFMP will not have any obvious direct impact on the poor as a separate group. The policy actions and conditions are designed to have broad effects across the whole community, however, in the design of the conditions special consideration was given to avoid possible negative impacts on the poor. For example, income tax relief to low-income earners will offset the regressive impact of increased import duties. Subsidies will be minimized, but justifiable subsidies such as to the copra industry will be considered.

8. Even with the best design, it may be impossible to avoid effects on the poorest sections of the community. Although the fiscal stabilization actions will have indirect effects due to changes in prices of goods bought and sold by the poor, such effects will be impossible to directly measure in advance. Increased pressure on Government services will affect the poor, but the program loan aims to avoid collapse of the most sensitive service delivery areas, which is likely without program assistance.

C. Methodology

9. ADB's methodology for social impact assessment of program loans notes that analyzing the specific impact of program loans and specific policy actions on economic conditions is difficult. Social impact, and therefore the impact on the poor, reflects the economic impact. No specific indications or measures quantify the impact of reforms on specific groups in the community. However, the FFMP recommends the establishment of the Economic Policy, Planning and Statistics Office (EPPSO), which will be responsible for monitoring the poverty impacts of the FFMP.

10. The methodology to be used in assessing the impact of the FFMP follows ADB's agreed-upon methodology. Three scenarios are presented. Scenario 1 assumes that none of the recommended reforms under the FFMP are implemented. The result will likely be the collapse of the Government's essential public services that currently form a social safety net to the poor. This could force the Government into commercial borrowing to fund its short-term cash flow and perpetuating recent imprudent financial practices. The lack of reform measures will limit the ability of the Government to use the renegotiated economic provisions of the Compact most effectively.

11. Scenario 2 assumes that the Government will implement reforms under the FFMP, but without external financial support. Given the lag period involved in the effect of some of the reforms and the seriousness of the short-term cash flow situation, the Government is still likely to experience a collapse of social services in the short term. In the long term, the reforms will have a positive effect on the ability of the Government to use the assistance forthcoming from the Compact renegotiations to support pro-poor growth. This positive impact will only be apparent after significant pain and a long adjustment period.

12. Scenario 3 envisages that the Government will undertake reforms supported by the FFMP loan. This assistance will support the Government's public services in the short term and avoid collapse of the social safety net by stabilizing the fiscal situation and then establishing sustainable revenue prospects. Fiscal policies will be a tightened and spending priorities rationalized, which will involve a short to medium-term adjustment period. The implementation of reforms will have a positive impact on the ability of the RMI to use funds forthcoming from the renewed economic provisions of the Compact.

13. The impact of the FFMP is considered from four perspectives through which the scenarios will affect the poor: (i) demand for unskilled labor, (ii) the prices of the goods bought and sold by the poor, (iii) public transfers (transfers minus taxes) to the poor, and (iv) access to public and rationed goods and services. The impacts will then be grouped under four categories: (i) direct effects, (ii) indirect effects, (iii) macroeconomic effects, and (iv) effects on vulnerable urban groups (VUG) who may become poor due to the project effects.

14. If we look at the poor as largely rural, then the impact of the FFMP is likely to be minor given that the poor survive largely on a subsistence basis. The one exception is the only cash crop on the islands, copra, which the Government heavily subsidizes. In addition, education and health services to the rural areas are rudimentary, but fiscal problems will likely have an effect. The effect in the urban areas is likely to be greater, but just as difficult to identify.

D. Policy Actions with Significant Impact on the Poor

15. As noted in para. 7 the policy actions of the FFMP appear to have little direct impact on the poor. They will, however, alleviate the impacts on the poor of the no-reform scenario and establish the foundation for long-term pro-poor growth. The indirect effects will be spread across the whole program and will be examined in the context of the scenarios proposed earlier.

E. Three Scenarios

1. Scenario 1: No Reform

16. In this scenario, the Government public services will collapse with the inability to meet payroll and other existing financial obligations. Compact receipts coming from a two-year extension of the existing economic provisions may alleviate the problems in the medium term, but prospects for long-term growth will still be poor.[1] The funds will become available, as previous transfers that have been consumed by debt servicing requirements will finish in October. When the funds become available, it is likely that expenditure levels would return to previous levels, although, given the fiscal record of the RMI, the prospects of this money leading to substantial development are not good.

a. Direct Impact

17. With no reform there will be severe impacts on the poor, as public services are likely to collapse in the short term. Prospects for unskilled labor to secure employment will diminish as Government expenditures come under immediate pressure. Effects on the rural poor will not be tangible since they operate largely outside the cash economy. The major exception is the cash received from production of copra, which is heavily subsidized by the Government in the form of an artificially high purchase price. Already the rural areas are feeling the impacts, since the subsidized copra price has been lowered twice in the past six months. Since copra is the one significant cash-generating activity on the outer islands, cash incomes for those living in the rural areas will be significantly reduced. Additionally, transfers to local governments will possibly be affected although these are not significant items in the Government budget except for the Kwajalein local government (Ebeye).

18. The possibility of severe disruption to public services will affect the urban poor in a number of ways. Most notably services will be lacking as the Government restricts its services because of its cash flow problems. The possibility of the Government failing to meet its payroll will have a severe effect in households with single wage earners. Many public service wage earners also have sizable personal loans to service, so the possibility of a payroll disruption will have a compounding effect on the poorest households as debt accumulates.

b. Indirect Impact

19. The indirect impacts are longer term, but the outlook for unskilled labor in the longer term is poor given the long-term revenue prospects of the Government. Unskilled labor will find it more difficult to secure work as the services sector suffers from reduced Government expenditure. Prospects for transfers to the poorer members of the community will be dim given

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[1] The Compact provides for a temporary two-year extension of the economic provisions of the Compact if negotiations on renewal of these provisions are not completed. Formal negotiations have yet to commence and are likely to be lengthy, meaning that the likelihood of an extension is extremely high. A view is that the Compact funds are only available for capital and not recurrent expenditure, but the veracity of this information is unconfirmed.

that there is unlikely to be any improvement in the utilization of Compact funds. The economy is likely to remain relatively stagnant in the foreseeable future, with little likelihood of increased self-reliance.

c. Macroeconomic Impact

20. As Government financial reserves are already exhausted, there are no additional resources to draw upon to fund deficits. Contracting Government expenditure will impact on recurrent expenditures and hence the private sector. Prospects for unskilled labor will continue to deteriorate along with Government services. Increased Government borrowing to fund cash flow will exacerbate the lack of reserves and lead to a debt spiral as discretionary revenues have to be increasingly dedicated to debt servicing. Lack of social services can lead to social instability as unemployment increases with the flow-on effect from the lack of Government expenditure having a cumulative effect throughout the economy.

d. Impact on the Vulnerable Urban Groups

21. With no reform, the deterioration of public services will impact on vulnerable urban groups, considering vulnerable urban groups are predominantly urban. Just like the poor, vulnerable urban groups will feel the effects but will be able to offset the negative impact to some extent. Being predominantly urban gives vulnerable urban groups greater access to the migration option, through access to the US granted under the Compact. One apparent impact of the reduction-in-force program was the increase in out-migration to the US as staff reductions took place and the economy contracted. This option was open to the vulnerable urban groups but of course was not available to the poorest in the community. Many of the vulnerable urban groups who migrated have apparently taken up unskilled work in the US. If Government finances continue to deteriorate and expenditures restricted ,then retrenchments in the private sector are likely to occur resulting in vulnerable urban groups income earners becoming unemployed and entering the realm of the poor. Migration will be a major option.

2. Scenario 2: Reform Without Program Loan

a. Direct Impact

22. The dire fiscal situation of the Government's finances means that reform without assistance from the program loan will cause significant problems, as in Scenario 1. The impacts on the poor will result from the collapse of health and education services (para. 17). The rural poor will continue to suffer in the short term, experience indicating that in times of fiscal problems, resources are more tightly concentrated in urban centers. But, as noted in para. 14, deterioration cannot reduce services much on the outer islands because of their current rudimentary state.

23. The urban poor are likely to suffer more than the rural poor in both a relative and absolute sense as services cease or salaries are unpaid. Unlike in the PSRP, the loss of jobs and salaries is unlikely to be permanent, although hardship will be severe in the short to medium term. However, the urban poor will also benefit earlier from the recovery as the reforms begin to yield results and improvements from Compact assistance spread through the communities. Little of these benefits will accrue to the outer islands in the medium term until better mechanisms are developed to distribute wealth more equitably and efficiently.

b. Indirect Impact

24. Without assistance, the Government cannot avoid the reality of a short-term budget crunch. Labor markets, especially for unskilled labor, will be depressed in the short to medium term, but after a painful adjustment period prospects will brighten. There is also less likelihood that the reforms will be adopted quickly. The considerable pain can lead to backtracking on reforms without including mitigating measures. Without the accompanying technical assistance for policy reform, implementation lags and policy errors can delay the recovery and exacerbate problems in the economy. There will be little prospect for maintaining transfers in the short term, including subsidies to the outer islands. In the medium term, services will stagnate but possibly improve in the longer term.

c. Macroeconomic Impact

25. The contraction of the Government's budget will limit the ability of the private sector to drive any sort of employment growth. Job prospects especially for the unskilled will remain bleak. Prices will probably increase as the private sector contracts, resulting in reduced competition. This may be partially offset by downward pressure on wages, the major input into prices in the RMI. Restricted public transfers in line with the Government's tight budgetary situation can lead to social and economic instability. This can be exacerbated by poor social services to provide the necessary safety net. Prospects in the longer term will improve after a painful adjustment period.

d. Impact on Vulnerable urban groups

26. As the Government services reach crisis, vulnerable urban groups will possibly lose jobs or at least experience problems when the Government cannot meet its payroll obligations. Job prospects are likely to be severely curtailed for both skilled and semiskilled workers. Prices will be affected by increases in import duties as the Government tries to shore up its revenue. However, with a weak labor market, there could be downward pressure on wages. There will be increased pressure on public services and vulnerable urban groups will suffer as the services deteriorate and possibly become more expensive.

3. Scenario 3: Reforms with Program Loan

27. The goal of the FFMP is to stabilize the Government's fiscal position and thereby stabilize the overall economy. The assistance should alleviate the current crisis by increasing Government revenues to sustainable levels while maintaining the social safety net for the poor. The scale of the problems facing the Government will cause a downturn in the economy, but it will be followed by significantly improved prospects in the medium to long term. The assistance should prevent job losses and set the path for moderate employment growth.

a. Direct Impact

28. The assistance should at least maintain existing employment without the need for any retrenchments in the Government. Tightening of fiscal policy will probably put pressure on certain private sector operators and result in some private sector layoffs, but these should be minimized. As import duties are increased, minor increase in prices should be partially offset by compensating income tax relief for low-income earners. There is little prospect in the medium term of the Government's finances being able to cope with increases in the copra-buying price despite the political nature of the subsidy. Public transfers and essential government services

should be maintained; however, these transfers and nonessential services are likely to be rationalized as the Government refines its spending priorities.

b. Indirect Impact

29. In the medium term, it is expected that improvements to the policy environment in the private sector combined with a more disciplined fiscal policy can lead to moderate employment growth for unskilled labor. Minor price rises can impact on people with fixed incomes such as retirees and those that receive nuclear compensation payments. Public transfers will be rationalized, but stabilization of the Government's fiscal position may allow the Government to be more sympathetic to consideration of pro-poor transfer payments such as to the outer islands. Additional privatization, corporatization, and contracting out can restrict directly provided government services, but there could be efficiency gains with the private sector taking over some of these services, and assuming that institutional capacity exists in the public service to oversee contracts.

C. Macroeconomic Impact

30. Adjustment in the fiscal policy with the review of the taxation systems to make it more progressive without negative impacts on private sector incentives should support employment growth at a moderate level. The key will be to ensure that the review of the tax regime promotes the private sector and maintains incentives. The proposed increases in import duties will have some effect on prices, and the private sector passes changes in the tax structures on to the consumers in the form of higher prices. Promoting a competition policy can assist in minimizing price increases from tax changes. Fiscal balance should also allow public transfers to continue to the most needy, with some justifiable rationalization based on transferring wealth to those most in need. Additionally, the fiscal balance should ensure that essential services are maintained at levels to support the poor.

d. Impact on Vulnerable urban groups

31. The vulnerable urban groups should be able to maintain their employment, though there may be some layoffs in the private sector from the flow-on effect as the Government rationalizes its spending patterns. Vulnerable urban groups will experience increases in prices, but the lower income earners will experience tax relief. Public transfers to vulnerable urban groups will probably decrease with the rationalization of these transfers, but vulnerable urban groups will benefit from the continuation of essential social services such as education and health even though some more peripheral services may be terminated.

LONG-TERM CASH FLOW FORECAST
($ million)

Item	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
A. Compact																			
1. Untied Funds	21.6	21.9	21.9	21.9	21.7	21.7	21.7	21.7	21.7	19.5	19.5	19.5	19.5	19.5	17.6	17.6	17.6	17.6	363.7
2. Adjustment			2.2	2.2															4.4
Total	**21.6**	**21.9**	**24.1**	**24.1**	**21.7**	**21.7**	**21.7**	**21.7**	**21.7**	**19.5**	**19.5**	**19.5**	**19.5**	**19.5**	**17.6**	**17.6**	**17.6**	**17.6**	**368.1**
B. Trust Fund			15.3	15.3	13.0	13.0	13.0	13.0	13.0	11.7	11.7	11.7	9.8	9.8	8.8	8.8	8.8	8.8	185.5
C. Net Inflow (A-B)	21.6	21.9	8.8	8.8	8.7	8.7	8.7	8.7	8.7	7.8	7.8	7.8	9.8	9.8	8.8	8.8	8.8	8.8	182.8
D. Debt Service																			
1. RMI Bonds	20.2	20.3																	40.5
2. ADB loans	0.4	0.4	1.1	1.3	1.5	2.1	2.5	2.7	2.6	2.9	2.8	2.7	2.7	3.0	3.1	3.2	2.4	2.6	40.0
3. Others		1.3	1.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2								4.0
Total	**20.6**	**22.0**	**2.2**	**1.5**	**1.7**	**2.3**	**2.7**	**2.9**	**2.8**	**3.1**	**3.0**	**2.7**	**2.7**	**3.0**	**3.1**	**3.2**	**2.4**	**2.6**	**84.5**
E. Surplus/Deficit (C-D)	1.0	-0.2	6.6	7.3	7.0	6.1	6.0	5.8	5.9	4.7	4.8	5.1	7.0	6.7	5.7	5.6	6.4	6.2	97.7

ADB = Asian Development Bank; RMI = Republic of the Marshall Islands.

Notes:

1. The 2002-2003 compact extension period is based on an adjusted increase of $2.2 million per year. This represents the excess of the weighted average in the last 15 years (1986-2001) over the most recent annual receipt under the Compact.
2. The 2004-2017 Compact revenue projections are based on a worst case scenario assumption, which factor s in a 10percent step-down every five years. This is similar to the arrangement under the 1986-2001 Compact funding.
3. The untied portion of the Compact Section 211 and 217 funding does not include the Kwajalein Atoll Development Authority/Kwaljalein landowner payments.
4. Contributions to the trust fund will represent 60 percent of the untied funds for the first 10 years, plus 100 percent of the adjustment in 2002-2003 and 50 percent thereafter.

PROGRAM FRAMEWORK

Design Summary	Performance Indicators/Target	Monitoring Mechanisms	Assumptions/Risks
Goal Achieve sustainable growth and poverty reduction without continued reliance on external assistance	• Per capita income • Poverty indicators • Unemployment rate • Budget balance • Corpus in Marshall Islands Intergenerational Trust Fund (MIITF)	• National income accounts • Budget documents • Balance sheet of MIITF • Poverty assessment and human poverty index	• Political stability • Reform-minded government continues in power. • Compact is renewed with adequate economic financial support.
Objectives 1. Sustainable income flow for future generations	1.1 Governance of MIITF is strengthened. 1.2 Resources for MIITF are mobilized with a view to attaining $0.5 billion (in 2000 prices) by 2018.	• Appropriate legislation, statutes, and appointments for MIITF • Quarterly accounts of MIITF	• Adequate political will to implement structural reforms • Adequate institutional capacity to implement reforms • Adequate financial resources (including Compact funds) • Adequate financial returns on MIITF
2. Strengthened public sector financial and economic management system	2.1 Clear and robust systems of annual and medium-term budgeting, financial control, accounting, performance audit and reporting to Nitijela established. 2.2 System for providing economic policy advice to the Government strengthened 2.3 Effectiveness of capital expenditure projects in the public sector improved 2.4 Corporate governance of	▪ Budget documentation, Cabinet Mmnutes, report from the minister of finance on budget office and accounting system ▪ Publication of project evaluation manual and the rules on competitive bidding	

		private sector enterprises (PSEs) strengthened		
3.	Stabilized fiscal position	3.1 Government revenues increased 3.2 Government expenditures restrained to increase no more than 5 percent annually	Budget documents	• Tax collection on enforcement is carried out
4.	Improved effectiveness of public service	4.1 Efficiency of civil service improved to match standards for staffing vis-à-vis service delivery 4.2 High-quality manpower attracted to civil service 4.3 Increase in number of employees with college degrees or professional qualification	Public Service Commission regulations, review, reports on implementation of recommendations and on training workshops	• No political interference and appointments
5.	Enhanced policy environment for the private sector	5.1 Land lease simplified for collateral purposes 5.2 MIDB/commercial banks lending against leased land as collateral 5.3 Incidence of nonperforming loans reduced 5.4 Access to credit for small and new businesses improved; measured by new business starts 5.5 Competition in private sector strengthened	Legislation and balance sheets of banks Loan portfolio assessment Report on private sector activity	• Government disengages from activities that can be more efficiently performed by the private sector • No general economic downturn

Outputs			
1.1 Strengthened governance of MIITF		• Statute of MIITF published • Issuance of implementation guidelines and operational procedures • Proof of appointment of Advisory Committee and Fund Manager	Same as above • Nitijela continues to approve annual allocation to MIITF
1.1.1 Publication of the statutes of the MIITF with necessary changes made to ensure that the objectives of the fund are met	May 2001		
1.1.2 Appointment of trustees/board of MIITF	August 2001		
1.2 Allocation of resources to MMTF	Starting October 2001		
1.2.1 At least $20 million allocated very year to MIITF	Proof of deposit of • 70 percent of nonearmarked funds in FY2002 • 60 percent in FY2003 • 100 percent of Compact adjustment • Other donor contribution • Allocation for the next 17 years	• Audited financial statements of MIITF	
2.1 Robust system of budgeting and accounting		• Copy of budget document presented to Nitijela	• MOF is staffed with competent personnel.
2.1.1 Budget for FY2002 presented in improved format	• Budget preparation by September 2001 in revised format	• Same as above	• Budget procedures and changes are accepted by Nitijela.
2.1.2 Multi-year budget framework presented	• Multiyear budget prepared starting FY2003 • Completion by early 2002	• New/upgraded accounting system in place • Reports generated in accordance with internationally accepted	• Government gives due recognition/powers to Economic Policy, Planning and

2.1.3 Budget procedures, budget office, and accounting system strengthened	• Reports are meaningful and provides comparative data for better decision making	norms	Statistics Office (EPPSO)/National Policy Coordinating Committee (NPCC).
2.2 Strengthened capacity for economic policy advice			
2.2.1 A strong Economic Policy, Planning and Statistics Office is established	• Appointment of EPPSO and Nitijela approval • EPPSO recommendations are accepted by NPCC and approved by Cabinet appointed by May 2001	• Appointment of NPCC • Minutes of NPCC meetings	
2.2.2 A high-level National Policy Coordinating Committee (NPCC) established	• NPCC meets regularly		
2.3 Improved effectiveness of capital expenditure projects in public sector			
2.3.1 Publication of project appraisal manual to be used for all projects above $250,000	October 2001 • All projects are screened according to guidelines prior to Cabinet/Nitijela approval	• Published project appraisal manual and revised bidding procedures	• Minimal political/government interference
2.3.2 Competitive bidding procedures followed for all procurements above $100,000	October 2001		
2.4 Strengthened corporate governance in the public sector			
2.4.1 Publication of study specifying management practices and standards for governance of PSEs in the RMI and program for	October 2001 • Reduction of subsidy to PSEs and review of copra subsidy • PSEs are financially viable and providing quality service	• Progress reports of TA consultants • Financial reports of PSEs and government financial statements	

reduction of subsidies and their implementation		• EPPSO/PCU assessment	
3.1 Increased government revenues			
3.1.1 Comprehensive tax review for improving efficiency, equity, and reliability of tax system in the RMI and implementation of its recommendations.	September 2001 • New structure approved by Nitijela and implemented	• Consultants report and recommendation	
3.1.2 Increased import duties to no less than 8 percent	September 2001 For implementation starting FY2002 • Proof of collection	• Nitijela approval • MISSA financial reports	• Nitijela approval is obtained
3.2 Restraint in Government expenditures	July 2001	• Nitijela approval • Government plan for control of referral costs • MOHE reports on health sector expenditures	• Political and administrative will to implement overseas referral guidelines
3.2.1 Contribution to health funds increased to 3.5 percent			
3.2.2 Cap on overseas referral cost and on health expenditure subsidies and increased provision for island health care	October 2001 • Reduction of subsidy for overseas referrals to $1.2 million in FY 2002 • Number of referrals reduced • Stricter guidelines set and implemented		
3.2.3 Freeze on public sector salaries and 5 percent cap on increase in growth in general funds	September 2002/2003 • Budget guidelines issued to ministries • FY2002 general fund	• Budget documents	

expenditures	expenditure not exceeding $31.5 million		
3.2.4 Action plan on subsidy reduction is formulated and implemented.	December 2001 • No provision for subsidy for PSEs starting FY2003		
4.1 Improved efficiency of civil service			
4.1.1 Review on improving the public service is prepared and its recommendations implemented	June 2002	• Consultant reports	• Availability of resource and training facilities
4.1.2 In-service skill enhancement courses are undertaken	September 2001 • Number of training programs conducted	• Proof of training programs/workshop	
4.1.3 Feasibility study for civil service based on competitive examinations is made.	March 2002		
5.1 Enhanced policy environment for private sector			
5.1.1 Legislation enacted to facilitate use of land as collateral	April 2001 • Land used as collateral	• Nitijela Act • Loan portfolio reports	• Absence of political interference
5.1.2 MIDB's role reviewed and effort made to recover non-performing loans	December 2001 • Loan recovery and portfolio performance • Decline in NPL amount in MIDB financial statements	• Consultants fielded • Loan recovery and portfolio reports	
5.1.3 MIDB redirected to provide business advisory services with access to commercial bank credit	December 2001 • MIDB restructured and management changed	• Revised operating regulations for MIDB	

5.1.4 Feasibility study prepared to develop microcredit facilities 5.1.5 Program for strengthening competitive environment in private sector is implemented.	December 2001 • Funds available for microcredit December 2001	• Report	
Inputs			
• Repayment of arrears and high-cost debt ($5 million) • Support to fudget and MIITF ($4.5 million) • Cost of accounting system/tax collection improvement and specialist inputs ($2.5 million)	• Tax collection	Disbursement statements	

INELIGIBLE ITEMS

1. The proceeds of the proposed loan may be used to finance the foreign exchange expenditures for the reasonable cost of imported goods (excluding any duties or taxes) required during implementation of the Program. All imported goods financed from the proposed loan must be produced in, and procured from, the Asian Development Bank's (ADB) member countries.

2. Notwithstanding the provision in para. 1, no withdrawal may be made for

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

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

(ii) expenditure for goods intended for a military or paramilitary purpose or for luxury consumption;

(iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification;

(iv) expenditures for goods supplied or to be supplied under any contract that a national or international financing institution or any other financial agency has financed or agreed to finance, including any contract financed or to be financed under any loan from ADB; and

(v) expenditures incurred more than 180 days prior to the date of effectiveness of the loan.

CONDITIONS FOR TRANCHE RELEASES

		Date Completed
A.	**First Tranche Conditions**	
(i)	Provide Cabinet paper reorganizing the tax and revenue activities into a separate division, headed by an assistant secretary to improve efficiency and effectiveness.	May 2001
(ii)	Issue Instruction from the Office of the President that any request for funding outside of the appropriated budget for any government instrumentality of private sector enterprise (PSE) will be reviewed by both the Ministry of Finance (MOF) and Budget Coordination Committee prior to submission to the Cabinet for consideration.	May 2001
(iii)	Issue instructions to establish in the Office of the Chief Secretary, the Economic Policy, Planning and Statistics Office (EPPSO), which will absorb the existing Office of Planning and Statistics (OPS) so that it can effectively deliver economic policy advice and program/policy evaluation results to the National Policy Coordinating Committee (NPCC).	May 2001
(iv)	Publish the statutes of the Marshall Islands Intergenerational Trust Fund (MIITF) and/or regulations or guidelines in relation to MIITF to ensure that the objectives as stipulated in para. 64 of the RRP are met.	May 2001
(v)	Enactment of Land Registration Authority Act by Nitijela to improve certainty of land ownership and in conjunction with the Real Property Mortgage Act to facilitate the use of land as collateral.	April 2001

B. Second Tranche Conditions

(i) The Nitijela shall have passed legislation raising import duties on alcohol and tobacco to at least pre-1999 levels.

(ii) The Nitijela shall have passed legislation raising the general import duty to not less than 8 percent and increasing the tax-free threshold on income to offset the negative effects on low-income earners.

(iii) The Nitijela shall have passed legislation to restore the employer and employee contributions to the health fund to 3.5 percent each.

(iv) The Government shall have prepared and presented FY2002 budget to Nitijela in an improved format presenting more information on the expenditures by Government institutions, with the exact format to be determined in consultation with the Pacific Financial Technical Assistance Centre (PFTAC) budget adviser, clearly segregating recurrent expenditures, capital expenditures, one-time expenditures and prior-year liabilities.

(v) The Nitijela shall have passed a budget for FY2002 with a maximum 5 percent cap on general fund expenditure growth, starting from a baseline amount of $29.5 million for FY2001, excluding certain one-time expenditures and payment of prior-year liabilities as mutually agreed upon with ADB.

(vi) The Government shall have made MIITF operational with $1.8 million provided under the ADB Public Sector Reform Program (PSRP) loan and with other contributions from the Government

(vii) The Government shall have ensured that:
- (a) the MIITF has become operational, i.e., a board of directors has been appointed, an advisory committee has been appointed, an independent auditor has been appointed, one or more fund managers have been appointed and investment guidelines have been approved; and
- (b) the capital of the MIITF cannot be used as collateral for borrowings of the Borrower.

(viii) MOF shall have deposited into MIITF 100 percent of the Compact adjustment increase and not less than 70 percent of the nonearmarked portion of the economic provisions of the Compact available during the first year of the two-year transition period beyond October 2001.

(ix) The Nitijela shall have passed legislation obliging the Government to deposit funds into MIITF as follows:
- (a) $1 million as and when second tranche is released and $1.0 million as and when third tranche is released;
- (b) 100 percent of the Compact adjustment increase and not less than 70 percent and 60 percent, respectively, of the nonearmarked portion of the economic provision of the Compact available during the two-year transition period beyond October 2001; and
- (c) the whole of any contribution to MIITF and 50 percent of any nonearmarked funds from the renegotiated Compact starting in FY2004.

C. Third Tranche Conditions

(i) The Government shall have caused MOF to provide proof that actual expenditures in FY2002 complied with the appropriations for FY2002.

(ii) The Nitijela shall have passed budget for FY2003 with a maximum 5 percent cap on general fund expenditure growth over the budget for FY2002.

(iii) The Nitijela shall have passed budgets for FY2002 and FY2003, maintaining a freeze on the salaries for public servants, elected officials, and contract workers during FY2002-03, i.e., until 30 September 2004, or until the date on which a review of the public service has been completed, whichever is earlier.

(iv) MOF shall have deposited into MIITF 100 percent of the Compact adjustment increase and not less than 60 percent of the nonearmarked portion of the economic provisions of the Compact available during the second year of the two-year transition period after 2001.

TECHNICAL ASSISTANCE FOR FISCAL, FINANCIAL, AND ECONOMY ADVISORY SERVICES

A. Technical Assistance

1. The Asian Development Bank (ADB) will provide, on a grant basis, technical assistance (TA) for (i) fiscal and financial advisory services and program coordination, (ii) economic strategy advice, and (iii) capacity building for a more efficient public service. The TA will provide an adviser and support the Program Coordination Unit (PCU) with consultant inputs to ensure compliance with the policy matrix, benefit monitoring, and management advisory support for activities mentioned in the policy matrix, and the third component will assist the Government to develop in-house competencies and capacity for public sector management. Specific tasks to be undertaken are as follows:

(i) prepare long-term program indicating the stages by which progress in budgetary self-sufficiency is to be achieved and conditions for sustainable development created;

(ii) strengthen the Economic Planning and Statistics Office (EPPSO) in the chief secretary's office which will

  (a) assist the Ministry of Finance (MOF) to ensure that, prior to presentation to Nitijela, the annual budget and medium-term budget framework (MTBF) reflect the overall strategic framework approved by Nitijela;

  (b) assist the Ministry of Foreign Affairs in Compact negotiations and assist MOF in negotiations with development finance institutions;

  (c) monitor and report on public sector investment programs;

  (d) appraise policy initiatives, programs, and project proposals by Government departments and agencies and advise the Cabinet on their appropriateness;

  (e) monitor and report annually to the Cabinet and Nitijela on the performance of the economy, effectiveness in using domestic and foreign funds (in particular Compact funds), and progress toward the goal of budgetary self-sufficiency; and

  (f) Improve the statistical system for monitoring economic and social development and progress in achieving sustainable development;

(iii) strengthen the capacity of the budget office in MOF to prepare clear and understandable annual budget estimates along the lines specified in the Program statement of the Government;

(iv) review and make necessary changes in the statutes of the Marshall Islands Intergenerational Trust Fund (MIITF) to ensure that the objectives of the fund are met;

(v) prepare a feasibility study for introducing microcredit institutions and other mechanisms that can facilitate small loans to lower income groups for productive investments; assess the potential for housing industry development to promote employment and small industries, and prepare a feasibility study for lending by Marshall Islands Development Bank (MIDB) in the housing sector both for construction companies and for household mortgagees;

(vi) assess of collusion tendencies, if any, in the private sector in the Republic of the Marshall Islands (RMI) and suggest an action program for strengthening the competitive environment in the private sector;

(vii) prepare a feasibility study for introducing a system of a prestigious civil service cadre with entry based on competitive examinations; and

(viii) other specialist inputs as may be deemed appropriate by EPPSO/MOF.

2. Estimated TA costs and their sources are in Table A10.

Table A10: Cost Estimates and Financing Plan
($'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. ADB			
1. International Consultants			
a. Remuneration	600		600
b. Per Diem	150		150
2. International Travel	60		60
3. Local travel		20	20
4. Communications and Report Preparation	10		10
5. Office equipment, Vehicle and Furniture	20		20
6. Contingency	85	5	90
Subtotal (A)	**925**	**25**	**950**
B. Government Financing			
1. Counterpart Staff/Legal assistance		120	120
2. Secretarial Services		30	30
3. Office Accommodation		60	60
4. Contingency		30	30
Subtotal (B)	**0**	**240**	**240**
Total	**925**	**265**	**1,190**

ADB = Asian Development Bank.
Source: Staff estimates.

3. Detailed terms of reference (TOR), including specific responsibilities and outputs and reporting requirements, will be prepared during implementation of the Fiscal and Financial Management Program (FFMP). The TOR may be modified or expanded, depending on specific requirements as determined by the program coordination unit.

4. A summary TOR for consultants currently anticipated and the estimated person-months follow.

(i) Tax adviser (3) to assist the Government in conducting a comprehensive study of the tax system both at the national and locals to improve tax efficiency, equity, reliability as well as tax collection and to harmonize tax policies between the national and local levels of government.

(ii) Macroeconomist and fiscal management specialist/program coordinator (12) to (a) assist the Budget Coordination Committee (BCC) in overall program implementation and coordination, (b) identify critical performance indicators and ensure compliance, (c) adjust program plans and implementation to changing variables, (d) coordinate various program inputs and outputs, (e) assist the Government in identifying consultant needs as they arise and in taking timely action, (f) assist BCC in preparing a multi-year budget framework for submission to Nitijela, (g) assist the Government in preparing and implementing a program for strengthening the budget office in MOF through appropriate staffing and management reform, and (h) advise the Government and ADB on the program progress and provide periodic reports.

(iii) Budget advisor (4) to (a) establish a clear and robust system of annual and medium-term budgeting, financial control, accounting, internal audit and reporting to Nitijela, (b) assist in the preparation of budgets and improve clarity of budget document, (c) strengthen financial policy advisory services to the Government, (d) improve the effectiveness of capital expenditure projects, (e) strengthen the corporate governance of state- owned enterprises, and (f) coordinate changes on the financial control and reporting system with ADB/PFTAC to ensure consistency with standard international practices.

(iv) Economist (6) to (a) assist the Government in institutionally strengthening the Economic Policy Planning and Statistics Office (EPPSO) to enable EPPSO to effectively deliver economic policy advice to the Government and to be able to serve effectively as the secretariat to the National Policy Coordination Committee (NPCC), (b) provide through EPPSO sound economic policy advice to NPCC aimed at promoting economic and social development objectives of the Government, (c) undertake studies, and review studies and reports available to or commissioned by the Government with a view to assisting the Government in formulating economic strategies, policies, programs and projects, and (d) assist the Government in formulating and appraising of investment projects.

(v) Public sector management specialist (6) to review of the public service management systems, pay scales, conditions, redeployment with a view to improving the productivity of the public service while containing the payroll costs within a prescribed ceiling; and prepare a feasibility study for introducing a system of prestigious civil service cadre with entry based on competitive examinations. The specialist will also help to establish linkage between input and output of the public sector.

(vi) Banking specialist/private sector specialist (3) to (a) review the financial condition and future role of MIDB with a view to recovering as much nonperforming debt as possible, (b) assist MIDB in redirecting its activities from direct lending to the provision of business advisory services with access to commercial bank credit, and assist the MIDB in formulating a feasibility study for introducing microcredit mechanisms that can facilitate small loans to lower income groups for productive investment, and (c) prepare an action program for strengthening the competitive environment in the private sector and set out a timetable for program implementation.

(vii) Expert on public enterprises (3) to (a) formulate an action plan for eliminating or reducing of all subsidies including the copra subsidy and finding alternative and more efficient ways to provide transfer payments to the outer islands to avoid economic dislocation, and (b) undertake and publish a study of the management practices and standards of corporate governance pertaining to the RMI's public sector enterprises.

(viii) Health care management specialist (2) to assist the Government in reviewing the health fund to balance expenditures with available revenues while ensuring adequate access to on-island and off-island care for those most in need.

(ix) Investment banking/trust fund specialist (2) to assist the Government in reviewing the statutes of MIITF with a view to revising them to ensure that the objectives of the Fund are met.

(x) Other specialists as required.