RRP:RMI 29658

ASIAN DEVELOPMENT BANK

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON A

PROPOSED LOAN

AND

TECHNICAL ASISSTANCE GRANTS

TO THE

REPUBLIC OF THE MARSHALL ISLANDS

FOR THE

PUBLIC SECTOR REFORM PROGRAM

December 1996

CURRENCY EQUIVALENTS

The Republic of the Marshall Islands uses the United States dollar as its currency.

ABBREVIATIONS

AMI	-	Air Marshall Islands
CAD	-	Civil Aviation Directorate
CIP	-	Capital Improvement Programs
CG	-	Consultative Group
CPI	-	Consumer Price Index
DCA	-	Director of Civil Aviation
EA	-	Executing Agency
FRTF	-	Financial Reserves Trust Fund
FSM	-	Federated States of Micronesia
GDP	-	Gross Domestic Product
GRT	-	Gross Revenue Tax
IMF	-	International Monetary Fund
KADA	-	Kwajalein Atoll Development Authority
MIAA	-	Marshall Islands Airports Authority
MIDA	-	Marshall Islands Development Authority
MIPA	-	Marshall Islands Ports Authority
MISC	-	Marshall Islands Shipping Corporation
MISSA	-	Marshall Islands Social Security Administration
MITA	-	Marshall Islands Tourism Association
MIVA	-	Marshall Islands Visitors Authority
MOTC	-	Ministry of Transport and Communications
MPW	-	Ministry of Public Works
MRD	-	Ministry of Resources and Development
OPS	-	Office of Planning and Statistics
PAT	-	Policy Advisory Team
PRP	-	Policy Reform Program
PSRP	-	Public Sector Reform Program
RIF	-	Retirement-in-Force
RMI	-	Republic of the Marshall Islands
TA	-	Technical Assistance
TTPI	-	Trust Territory of the Pacific Islands
UNDP	-	United Nations Development Programme
VAT	-	Value Added Tax

NOTES

(i) The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY1996 ends on 30 September 1996.

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

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LOAN AND PROGRAM SUMMARY

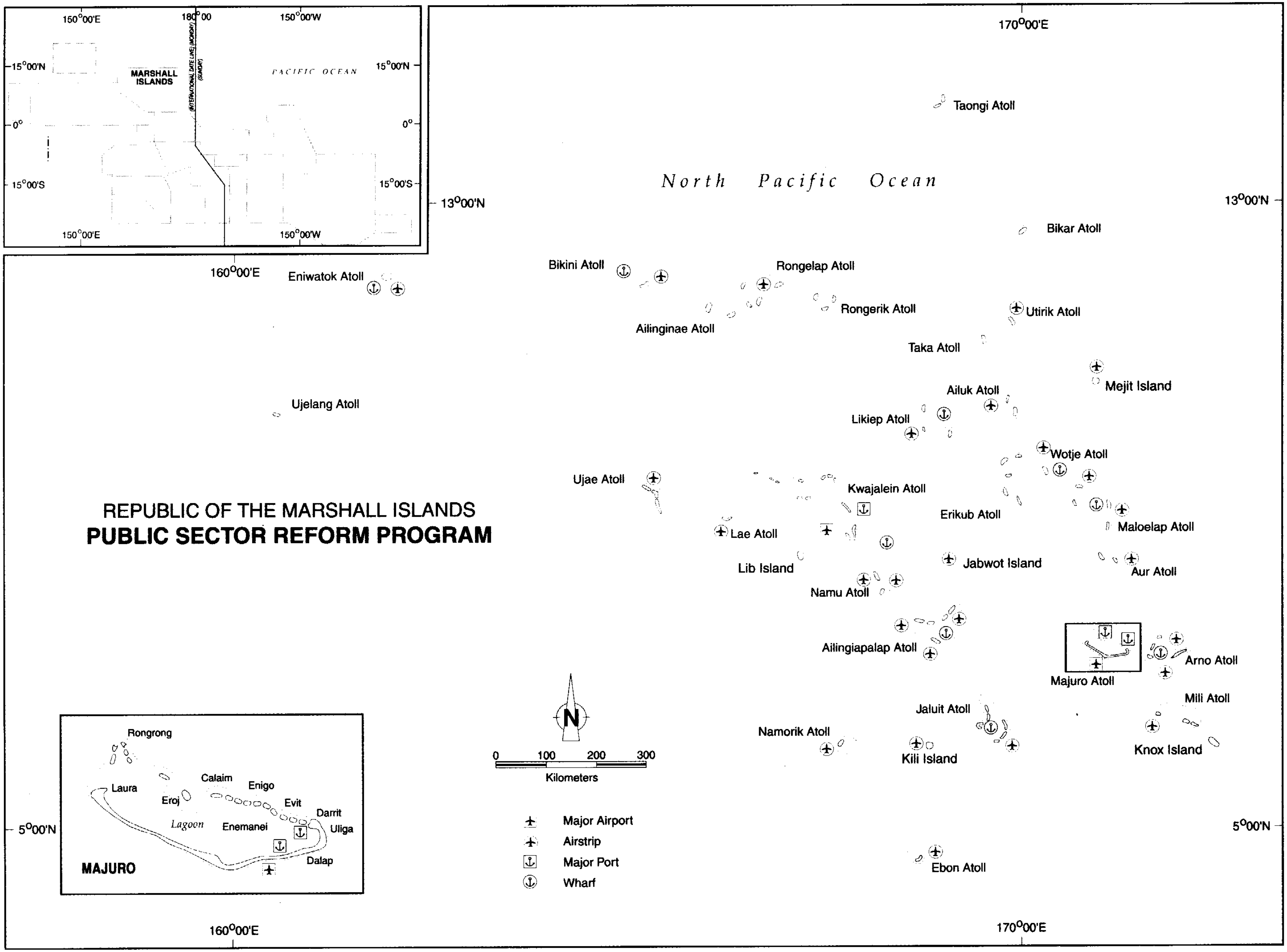
Borrower	:	Republic of the Marshall Islands
Classification	:	Primary Objective: Economic Growth
Environmental Assessment	:	Environmental implications of the proposed policy and institutional reforms were reviewed, and environmental interventions were incorporated, as required.
Rationale:	:	At a Consultative Group meeting, in December 1995, the Republic of the Marshall Islands (RMI) presented its Policy Reform Program prepared under Bank assistance to the external aid community, which endorsed it. It was recognized that the Republic needed to embark on a long-term reform program to avert the looming financial and economic crisis, and to set the country on a more sustainable growth path. The Government has requested Bank assistance to design and implement a policy reform program that will achieve an orderly adjustment while minimizing the social cost. The Public Sector Reform Program (PSRP) consists of a first set of reforms for implementation in 1996-1998.
Objective and Scope	:	The PSRP has three principal objectives: (i) to stabilize the Government's finances in the short term, (ii) to ensure the long term structural stability of the Government's finances, and (iii) to create an improved enabling environment for the private sector. The scope of the Program covers civil service reform, taxation reforms and reforms in the transport sector.
Loan Amount and Terms	:	Equivalent to $12 million from the Bank's Special Funds resources. It will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.
Utilization of Loan Proceeds	:	The proceeds of the loan are expected to be disbursed by October 1998 against a broad range of imports, subject to a negative list. Eligible imports incurred up to 180 days prior to loan effectiveness may be reimbursed from proceeds of the loan. The counterpart funds will be used by the Government to implement the Program.
Tranching	:	The proposed loan will be released in three tranches. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released in October 1997 and the third tranche before October 1998, both tranches being subject to compliance with the conditions for release.
Executing Agency	:	Ministry of Finance
Program Period	:	1 January 1996 - 31 December 1998

Program Benefits : The adjustment measures proposed under the Program are designed to assist RMI in beginning its transition to a more self-reliant economy; that is, to one that is less dependent on inflows of official transfers for economic support, and to one that can at least aspire to becoming independent of such transfers over the long term. Under present circumstances, the latter would not be possible. The economic future of RMI is tied to the development of private initiative and to a reduction in the pervasiveness of Government. Thus, while immediate gains are expected to arise from removing various economic distortions and from reallocating resources, it is the anticipated long-term gains that are potentially of greatest importance.

The PSRP will assist in mitigating some of the negative social impacts that will occur as a result immediate financial difficulties the Government is facing, and the resulting reduction of the size of the civil service. The beneficiaries of the PSRP will be the civil servants that will be retrenched, and their dependents, or 10 percent of the population of the country.

Technical Assistance : Technical assistance grants will be provided to support the implementation of the PSRP in three specific areas: (i) to the Rationalization Committee for a Program Coordinator ($515,000), (ii) for the Institutional Strengthening of the Transport Sector ($575,000), and (iii) in support of the Private Sector Unit ($760,000). Consultants will be engaged in accordance with the Bank's *Guidelines on the Use of Consultants*.

Program Risk and Safeguards : The principal risks are that (i) the Government's capacity to effectively implement reforms may prove insufficient; (ii) the Government's commitment to the current pace of reform may not continue as the retrenchment of a large number of civil servants may fuel strong political opposition to reforms; and (iii) the private sector may not respond as expected. The proposed Bank technical assistance (TA) will assist the Government with the implementation of the reform program and assure adherence to the agreed time table, while ensuring that the required momentum is being kept. Potential political opposition is addressed through a public information program that the Government intends to organize in early 1997, and through he provision of a social safety net for the retrenched civil servants. Separate Bank-financed TAs are assisting the Government in designing strategies for the development of the fisheries and tourism sectors, where the private sector will need to take the lead. This will lead to an improved policy environment in these sectors, in addition to the generally improved environment promoted by the PSRP.


REPUBLIC OF THE MARSHALL ISLANDS
PUBLIC SECTOR REFORM PROGRAM
North Pacific Ocean
MARSHALL ISLANDS
PACIFIC OCEAN
150°00'E
180°00
150°00'W
15°00'N
0°
15°00'S
13°00'N
160°00'E
170°00'E
5°00'N
Taongi Atoll
Bikar Atoll
Bikini Atoll
Rongelap Atoll
Eniwatok Atoll
Rongerik Atoll
Utirik Atoll
Ailinginae Atoll
Taka Atoll
Mejit Island
Ailuk Atoll
Ujelang Atoll
Likiep Atoll
Wotje Atoll
Ujae Atoll
Kwajalein Atoll
Erikub Atoll
Maloelap Atoll
Lae Atoll
Jabwot Island
Aur Atoll
Lib Island
Namu Atoll
Ailingiapalap Atoll
Arno Atoll
Majuro Atoll
Mili Atoll
Jaluit Atoll
Namorik Atoll
Kili Island
Knox Island
Ebon Atoll
0 100 200 300
Kilometers
Major Airport
Airstrip
Major Port
Wharf
Rongrong
Laura
Calaim
Enigo
Eroj
Evit
Darrit
Lagoon
Enemanei
Uliga
MAJURO
Dalap
96-1608 R

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on (i) a proposed loan to the Republic of the Marshall Islands for the Public Sector Reform Program; and (ii) proposed technical assistance in support of a Private Sector Unit. The Report also describes proposed technical assistance for (i) a Program Coordinator for the Rationalization Committee, and (ii) Institutional Strengthening of the Transport Sector, and if the proposed loan is approved by the Board, I, acting under the authority delegated to me by the Board, shall approve such technical assistance.

II. INTRODUCTION

2. Following the Consultative Group meeting for the Marshall Islands, held in Manila in December 1995, the Government requested the Bank for financial and technical assistance to facilitate the implementation of the Government's reform program. A Fact-Finding Mission visited the country from 18 to 31 May 1996, and the Management Review Meeting (MRM) was held on 25 July 1996. A Loan Appraisal Mission visited RMI from 9 to 18 September 1996. Loan negotiations were successfully completed on 18 November 1996.

III. BACKGROUND

A. General Setting

3. The Republic of the Marshall Islands (RMI), the Federated States of Micronesia (FSM), Guam, Kiribati, Nauru, Northern Marianas and Palau are all part of an extensive group of islands in the Pacific known as Micronesia. The RMI has a population of about 51,000, currently growing at an estimated rate of 3.6 percent per annum. The country 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 is concentrated in two main urban centers, Majuro and Ebeye. As with 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 country's physical beauty offers scope for the development of tourism. 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.

B. Historical Perspective

4. After World War II, the United Nations (UN) established the Trust Territory of the Pacific Islands (TTPI), comprising the Marshalls, as well as the Caroline (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 which came into full effect in 1986, when the UN Trusteeship was terminated.

5. 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 which may request reconsideration of any bill affecting customary law, particularly as it relates to land tenure.

6. 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 inter-ballistic missiles. Since 1947, the base has provided employment for 300-800 Marshallese who received wages 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.

7. During the first ten years of the trusteeship little progress was made with improving social or economic conditions. However, from the early 1960s, development expenditure was increased and a number of social welfare programs were introduced. These included feeding programs, school meals, programs for the aging, sports programs, community support and youth employment programs. Some of those were not adapted to Marshall Island conditions and the distribution of free food and school meals led to a decline in local food production. It also led to an increase in employees required to administer the programs.

8. Under the TTPI administration, while the infrastructure was improved, agricultural, administrative or technical skills were given less attention. At independence, the RMI inherited a top-heavy bureaucracy, almost no primary production, a population with health and social problems, and inadequate skills to plan or implement development policies.

9. In this setting, the country, and its new leaders, were ill-prepared for the challenge of turning the Marshall Islands into an independent economy that would offer good prospects to its citizens. Management of the country restricted itself to management of the finances, without a clear vision or concept of what development would mean for the Marshall Islands. As the country and its leadership are maturing, such a vision is starting to develop. Unfortunately, harsh measures will be needed in the short and medium term to realize such a vision and give the country direction beyond 2001, the year in which the current funding arrangements under the Compact of Free Association end.

C. Recent Economic Performance

1. The Compact of Free Association

10. Since the Compact of Free Association became effective in 1986, the RMI has been receiving considerable economic and technical assistance from the US, supplemented by federal grants and additional appropriations by the US Congress. While containing specific provisions on the relations between the two Governments in different 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.

11. Under the terms of the Compact agreement, the US pledged to provide grant financial assistance to RMI for a period of 15 years, ending in October 2001. The most important part of this assistance has been the base grant. There have also been annual payments earmarked for specific purposes, such as rent for the use of Kwajalein Atoll for defense and research purposes, a Nuclear Claims Trust Fund[1] (of $150 million), other non-recurring grant payments, and inflationary adjustments. The total financial assistance for the 15-year period, 1986-2001, is estimated to be

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[1] This Trust Fund manages claims awarded to individuals only.

$790 million, of which a total of $606 million will have been received in the form of regular annual payments. Two step-downs in the base grant in FY1992 and FY1997 are built into the agreement. Total Compact payments have been declining from 70 percent of gross domestic product (GDP) in the late 1980s to less than 50 percent at present.

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

13. These negative incentives have been 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. This has allowed current spending to rise even higher relative to production than would otherwise have been possible.

2. Agriculture and Fisheries

14. Agriculture and fisheries have traditionally been the mainstay of the productive economy. Although sectoral performance is difficult to assess because of the lack of reliable data the overall indication is that growth is slow or even stagnating. The contribution of agriculture to GDP has gradually increased from 3.5 percent in 1991 to an estimated 5 percent in 1995. This development is wholly attributable to the dramatic tripling of prices paid to copra growers by the country's sole buyer, the Tobolar Copra Processing Authority, in 1992, and to record harvests in 1995. The share of food crops and livestock in GDP continued to decline and now is at an estimated 3.5 percent. Fishing contributes around 8 percent to GDP.

15. With an Exclusive Economic Zone of over 2 million km^2, fisheries is considered as the sector having the largest potential for generating economic growth. At the same time, the sector is plagued by surveillance limitations, lack of skills, high domestic costs, foreign influence and inappropriate investment decisions. Deep-sea fishing, mainly for various tuna species, is dominated by foreign fishing fleets. The country has agreements with the US (through a regional multilateral treaty, for purse seining) and with Japan (pole-and-line, and increasingly long-line vessels). License income has averaged $3 million over the last few years.

16. According to the 1994 Household Survey, less than 50 percent of rural households own some form of vessel (boat or canoe). While more than 90 percent of rural households fish at least once a week, the two fishing methods most frequently employed are the fishing pole (from a vessel) and spear-fishing (onshore and inshore). Inshore and coastal fishing is predominantly a subsistence activity, undertaken by most households on a part-time basis. Fish makes an important contribution to the local diet on the outer islands. In the urban areas, consumption of fish is much lower, as a result of difficulties in transporting fish from the outer islands, low market demand, and high prices relative to imported canned fish and frozen meat.

3. Tourism, Manufacturing, and Construction

17. The tourism sector is in its infant stage. Over the last four years, an average of about 5,000 visitors a year arrived in the RMI. A high proportion of these were on business trips, while less than 1,000 visitors a year were on holiday or vacation. The Government has recently completed the construction of a 150-room hotel in Majuro, the management of which has been contracted-out to a

major Hawaii-based hotel operator. Under the Tourism Act 1991, the Marshall Islands Visitors Authority (MIVA) was established with the objective of developing and promoting tourism in the country while protecting its physical and cultural resources and heritage and maximizing local participation and content. The Historic Preservation Act has also important implications for tourism. Furthermore, the private sector has recently formed the Marshall Islands Tourism Association (MITA), an interest group that is intended to work closely with MIVA. Some of the country's attractions have been promoted in the US with active support from Continental Micronesia Airlines and Air Marshall Islands (AMI) but with limited success.

18. The RMI's secondary sectors are small, and employment opportunities relatively few. Collectively, the secondary sectors, including utilities and construction, constitute some 12-14 percent of GDP, and are dominated by construction activity. There is virtually no manufacturing, this being confined to a copra mill, a drinking water company, a ship repair yard, a dairy plant, a garment factory, and a brewery, the last three currently being inoperative. While a tourist sector is beginning and has potential for generating employment and value added, it is still limited.

4. Prices, Wages, and Employment

19. The rate of inflation in the RMI is measured by the consumer price index (CPI) for Majuro only, as there are no data for the other parts of the country. As the prices are recorded only quarterly in two supermarkets and two stores in Majuro, the CPI is highly erratic. Over the last three years, the rate of inflation averaged 5 percent a year, which is relatively high compared with the inflation rate in the US, and taking into account stagnant consumer demand. Inflation accelerated to 8 percent in 1995. It is suspected that this is a result of importers and retailers partaking in profit-maximization before the expected decline in real disposable incomes. A minimum wage of $1.50/hour was established in 1986, which 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. Wages are generally higher in the public sector than in the private sector.

20. Total formal employment was 8,810 in 1992, up from 5,834 in 1988, an average increase of about 5.2 percent per year. Of this total, 46 percent were employed by the public sector. Public sector employment grew at an average of 6.6 percent a year between 1988 and 1995. Labor force growth has been estimated at 4 percent over the 1988-1995 period.

5. Social Dimensions

21. Despite being a matrilineal society, Marshallese women lag behind men in all major indicators of education, health, employment, and social status. Educational opportunities have been limited for women and there is a shortage of skilled female labor. The large subsistence sector based on agriculture and coastal fisheries, combined with the traditional extended family system, has ensured that for most of the population the basic needs of food and shelter are met. However, social indicators show, that the Marshallese suffer from poor nutrition and dietary-related illnesses, have a low life expectancy, high infant mortality, are inadequately housed, have poor water supply and sewage disposal facilities, enroll too few children at school, and have falling per capita incomes.

22. Socioeconomic indicators in the RMI continue to lag behind indicators in other island countries in the Pacific despite the comparatively high per capita income. The crude birth rate has declined from 33.8 in 1983 to 32.2 per 1,000 in 1988, while the crude death rate declined from 4.1 to 3.4 per 1,000 over the same period. Life expectancy at birth has increased from 61 to 64 years for males and from 65 to 68 years for females. The infant mortality rate is high at 63 per 1,000. The population growth rate, which was 3 percent in 1983, accelerated to 4 percent in 1992. Indications

are that the rate is slowly decreasing and is about 3.6 percent at present. Common diseases among adults are diabetes and heart disease, mainly caused by an unhealthy lifestyle. The school enrollment rate is only 78 per cent at the primary level and 43 per cent at the secondary level.

6. Fiscal Developments and External Position

23. Recent budgetary operations are summarized in Table 1 which exhibits some alarming features of the RMI's budgetary situation. The importance of foreign (overwhelmingly US) grants as a source of Government revenue, and thus the limited capacity of the local economy to sustain current levels of Government expenditure or domestic economic activity, has been noted. The annual level of domestically raised revenue averaged $27 million during FY1991-FY1995, compared with an average annual level of Government expenditure of $71 million, thus indicating that only 38 percent of Government expenditure was covered by the mobilization of domestic resources during this period. While this proportion has risen over the past five years, largely as a result of increases in tax and nontax revenue, the level is both still a matter of concern and an indication of the degree of structural adjustment required.

Table 1: Central Government Finances, FY1991-FY1997 (millions of US dollars)

Item	FY1991	FY1992	FY1993	FY1994	FY1995	FY1996 (Est)	FY1997 (Proj)
Revenues & Grants	67.8	67.2	72.9	70.9	77.8	77.6	63.2
Tax	14.7	16.7	19.6	18.7	19.9	19.4	16.8
Non-Tax	9.4	7.7	8.6	9.2	15.4	11.1	7.5
Grants	43.7	42.8	44.7	43.0	42.5	47.1	38.9
Expenditure	74.0	87.7	84.9	83.4	100.4	75.3	65.4
Current	57.3	63.7	66.8	59.4	58.7	53.7	51.1
Wages and Salaries	17.6	18.8	19.4	21.0	21.9	20.7	18.8
Goods and Services	22.3	22.4	26.3	21.1	20.0	20.0	18.1
Counterpart funds							3.0
Subsidies	11.5	12.9	10.8	10.7	9.3	5.3	4.7
Interest	5.9	9.6	10.2	6.6	7.5	7.7	6.5
Capital	12.8	19.0	18.1	23.9	41.6	21.7	14.3
Overall Balance	**-6.2**	**-20.5**	**-12.0**	**-12.5**	**-22.6**	**2.2**	**-2.2**
Financing	10.5	23.9	12.0	12.5	22.6	-2.2	2.2
Net Borrowing	39.0	6.4	11.6	21.6	-13.4	-13.1	-9.5
Gross Borrowing	46.5	22.3	100.0	32.8	4.1	3.3	7.1
Repayments	-7.5	-16.6	-89.3	-14.4	-16.2	-16.4	-16.6
Use of Liquid Assets	-28.5	17.5	0.4	-9.1	36.0	10.9	11.7
Unreserved Financial Holdings	46.8	29.3	28.9	36.0	0.0	0.0	0.0

Source: Ministry of Finance, Republic of the Marshall Islands and IMF

24. Throughout the first half of the 1990s, the Government ran a large budget deficit, and one that was unsustainable. Despite attempts to raise revenue and to contain Government expenditure, no significant move to adjust to the FY1992 Compact step-down was made. Two major causes of the large and continuing deficit have been the high and increasing level of the Government's payroll and the high level of subsidies, particularly for AMI, as shown in Table 2. The deficits, moreover, were entirely financed by borrowing commercially abroad which, as noted, generated heavy debt-service obligations and led to the mortgaging of future Compact income streams. Since the level of debt servicing payments for outstanding debt incurred up to and through

FY1995 had, by the end of FY1995, already virtually exhausted scheduled Compact payments to the year 2001, the Government cannot borrow further to finance future budget deficits.

Table 2: Subsidies to Public Enterprises (millions of US dollars)

Item	FY1992	FY1993	FY1994	FY1995	FY1996	FY1997
Tobolar Copra Processing	2.7	1.9	2.2	2.7	0.6	0.5
Marshalls Energy Company	0.4	0.4	1.3	0.0	0.0	0.0
Air Marshall Islands	4.4	3.7	5.3	2.3	1.4	1.1
National Telecommunications Authority	0.3	0.3	0.0	0.0	0.0	0.0
Majuro Water and Sewer Company	0.4	0.3	0.2	0.5	0.5	0.2
Kwajalein Enterprises	0.2	0.2	1.1	1.1	0.9	0.9
Domestic Shipping	N/A	N/A	N/A	N/A	1.4	0.3
Total	**8.4**	**6.8**	**8.9**	**6.0**	**4.8**	**3.0**

Source: Ministry of Finance

25. Deficits were financed by running down the Government's financial holdings: net borrowing thus became negative for the first time in FY1995 and the Government's financial holdings were run down to around $2 million by the end of FY1996. The extremely serious implications of this situation are that there are now virtually no reserves with which to finance future budget deficits, and virtually no contingency funds with which to finance emergency expenditure.

26. The country's external position reflects the large share of consumption in the economy and the narrow resource base. Imports ($75 million in FY1995) have been large relative to GDP (75 - 80 percent during the last five years) and to exports ($17 million in FY1995). Exports (mainly copra and fish) have increased substantially over the last three years, as fish exports from the Chinese fishing fleet based in Majuro have been growing. The import requirements of the fishing fleet (mainly fuel), however, have partly offset the increase in exports.

7. Conclusion

27. Notwithstanding the central position of agriculture and fishing in the local economy, national economic activity is dominated by the services sector that contributes up to 70 percent of GDP. A very large but quantitatively unknown proportion of the value added by services derives directly and indirectly from the extensive public sector which, given the RMI's limited domestic revenue base, is essentially sustained by inflows of annual Compact and other grant payments. The private sector, which provides some 53 percent of formal employment, is largely based on servicing the needs of the Government apparatus and those of civil servants and their dependent families. The public sector accounts for about 47 percent of formal employment and public administration for 13-14 percent of GDP. Thus, the income flow and the income/employment multiplier generated by the public sector underpin a disproportionately large part of the domestic economy. The private sector cannot, at present, survive without continued transfers to the public sector.

D. Short and Medium-term Outlook

28. The short-term prospects for the RMI economy are bleak because (i) the prospective Compact payments through to 2001 have been mortgaged virtually completely to honor debt service commitments, thus effectively bringing forward the year 2001 to the present; and (ii) following the profligate use of the Government's financial holdings to finance a persistently large budget deficit, the level of such holdings has been reduced virtually to zero. With few, if any, resources with which

to finance continuing budget deficits, or even to overcome any cash flow problem emanating from a temporary gap between actual payment obligations and receipts, fiscal adjustment has been forced on the Government.

29. The external payments situation is also one of concern. Most food and virtually all consumer and other items have to be imported and, with only limited exports, the merchandise trade deficit remains very large: about 50 percent of GDP. This deficit is offset partly by a small surplus on services account, but overwhelmingly by large inflows of official grants whose long-term continuation is open to question. The RMI is thus being supported at levels of income and material consumption unrelated to domestic factor productivity, and at levels far beyond the capacity of domestic resources to sustain. Moreover, as a reflection of the RMI's recourse to commercial borrowing, Government debt and debt servicing have risen significantly, the former to 134 percent of GDP by the end of FY1995, and the debt-service ratio to 42 percent.

30. Thus, the failure to initiate adjustment a decade ago, and the decision to defer adjustment in the meantime by borrowing commercially in order to sustain current consumption, an inflated public payroll, and producer subsidies to loss-making ventures, are now forcing the Government into a series of abrupt, destabilizing changes. The only option available to the Government is to moderate the immediate recessionary impact of a fall in aggregate demand, and to promote greater economic self-reliance, through stimulating private sector development. The latter will take time, and a painful period of adjustment will continue until the private sector begins to take up the economic slack created in the wake of fiscal adjustment and public sector reform.

31. Private sector investments are contingent on the removal of the distortions to output and employment that have been created by the flow of Compact funds over the past decade, and aggravated by official policies to subsidize certain activities (including copra production). These distortions have to be removed if domestic production of internationally tradable goods and services is to materialize, and to become internationally competitive as well as sustainable in the context of the available resource base. In the RMI, the public sector and other non-internationally tradable activities have crowded out potential producers of tradable goods and services. Economic and structural reform of the kind being supported by the Government's Policy Reform Program (PRP) and the proposed program loan is essential to create an incentive framework conducive to private investment.

32. The medium-term outlook for the RMI economy is also bleak. The Government does not have the financial resources to sustain its current payroll, to continue to subsidize its state-owned enterprises, or to deliver its present level of services. The public service will have to contract. Both directly and indirectly — through the income/employment multiplier as well as via the high levels of personal indebtedness (especially among civil servants), and the typical degree of interdependence within extended families — domestic incomes and the GDP would fall; unemployment and underemployment would rise; material consumption and living standards would decline; malnourishment and poverty could increase; and health and education services could suffer. Such a scenario, which to some extent is inevitable, would offer nothing but bleakness unless a reform program could be introduced in the meantime to provide at least some longer term hope and some softening of its impact.

33. While it would be as inappropriate for the Bank as it has been for the Government to choose the likely avenues for successful economic endeavor, there would seem prima facie to be considerable potential for increased fishing and tourism, provided the domestic policy environment is conducive and not distorted in favor of nontradable activities. Moreover, while agricultural potential is severely limited, the People's Republic of China has obtained some promising technical results in fruits and vegetables in Majuro, as has the Government which is supporting horticulture and poultry

projects. Thus, even though there does not appear to be any single economic activity or large enterprise in the RMI that can be expected to absorb the number of public servants that are to be retrenched in the short term, the future holds out the longer term hope of growing employment in a large number of small commercial and/or subsistence activities, provided that there is a supportive policy environment. It is to the latter that the PRP is fundamentally directed.

E. Public Sector Institutions

34. The public sector, defined as those areas of the economy where decisions on allocation of resources are principally made by the Government and not by the private sector through market forces, is overwhelmingly dominant in the RMI economy. The national and local Government administrations not only provide for an important share of formal employment in the economy, but also own and control a large number of corporations and statutory bodies that together account for much of the economic activities in the country. 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. The civil service, which accounts for around half of public sector employment, has grown by 25 percent over the last five years.

35. Public administration in the RMI consists of the national civil service—under the responsibility of the Public Service Commission —the Kwajalein Atoll Development Authority (KADA), the Marshall Islands Development Authority (MIDA) and 24 local Governments. The national civil service employs an estimated 2,300 persons, up from 1,800 in 1989. The number has been estimated using the payroll records of the Ministry of Finance. Until 1 January 1996, the Government administration was organized into ten ministries. Since then, the Government has made a start with the implementation of public sector reforms, and reduced the Government by two ministries.

36. MIDA was established in 1984 as the authority which investigates, develops, and implements social and economic development programs and projects. It was created to coordinate Government actions in regard to the development of public and private businesses and, as such, is regarded 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 mainly used for debt servicing, and MIDA is losing its importance. KADA was set up in 1985 to plan and implement development activities on Kwajalein Atoll, with a view to improving living conditions in Ebeye. KADA funding is from the Kwajalein portion of Section 211. With this source drying up, KADA has reverted to borrowing in recent years.

37. There are 24 local Governments, each typically consisting of an elected council, a mayor, several appointed local officials and the local police force. The local Governments are substantially dependent on the national Government for financing, since they can raise few taxes of their own, e.g., taxes on beer and liquor.

F. Public Sector Performance

38. A number of studies have been commissioned over the last ten years to analyze the civil service. These studies came to the conclusion that the public service faces a number of constraints, the most important being its organization and staffing, its policy-making capacity, and the shortage of adequate skills of many staff members. This is a reflection of the relatively short time since self-governing status was achieved, and the difficulties faced by the education system in meeting the overall objectives of the country. The civil service is hampered by duplication and functional overlap, with the result that the responsibilities are not clear and accountability suffers. Recruitment and employment practices often lack objectivity so that candidates are not matched with

identified needs. There also appears to be a serious problem of delegation with practically all decision-making power in the hands of the Cabinet.

39. Staff motivation and performance are widely regarded as poor for a number of reasons. There is a mismatch of qualifications with positions. Few job descriptions exist, and even when they do, they are not clear, which adversely affects job performance. There are currently 28 pay scales in the civil service, covering all personnel. This is a large number by the standards of most civil service administrations. It makes it more difficult to make a distinction between different positions and makes performance evaluation harder. There is an almost complete absence of delegation within many areas of the Government—for example, ministers must sign requisitions for all items, including office supplies.

40. Public enterprise performance ranges from very bad to reasonably good, but can be said to have generally improved in recent years, with the decrease in reliance on subsidies. Most public enterprises are characterized by a considerable influence on their operations by the Government, which has a majority representation on the board of directors in most cases. Only in a few cases is management of these enterprises professionalized.

G. External Assistance to the Public Sector

1. The Bank

41. The Bank has provided six loans totaling $31.05 million to the RMI since it joined the Bank in April 1990[1]. The Basic Education Development, Health and Population and Majuro Water Supply and Sanitation projects are under implementation. Technical assistance grants totaling $9.6 million for 24 technical assistance projects have been provided as of October 1996 with 14 completed. A number of the ongoing projects contribute directly or indirectly to the Government's PRP and can be considered to be logically connected to the PSRP. Because the PSRP was designed after the approval of these loans, some coordination and sequencing problems are occurring, which are being addressed by the Government with Bank assistance[2].

a. Loan Projects

(i) Basic Education Development

42. The Project is to upgrade the standards of all primary and secondary education teachers, through training, curriculum development, and fellowships, and to upgrade a number of facilities. The Project has assisted in focusing the Government's attention on the problems and inefficiencies in the education sector, and an evaluation has started to assess how a better and more effective service delivery can be achieved with less staff resources.

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[1] Loan No. 1102-RMI: *Fisheries Development*, for $6.95 million approved on 26 September 1991; the loan is to be closed shortly.
Loan No. 1218-RMI: *Emergency Typhoon Rehabilitation Program*, for $0.5 million approved on 28 January 1993 and closed on 11 March 1994.
Loan No. 1249-RMI: *Basic Education Development Project*, for $8.0 million approved on 9 September 1993.
Loan No. 1250-RMI: *Majuro Water Supply*, for $0.7 million approved on 9 September 1993; the loan is to be closed shortly.
Loan No. 1316-RMI: *Health & Population Project*, for $5.7 million approved on 22 September 1994.
Loan No. 1389-RMI: *Majuro Water Supply and Sanitation Project*, for $9.2 million approved on 29 September 1995.

[2] A Portfolio Review Mission visited the country from 8 to 25 October 1996

(ii) Health and Population

43. This Project aims at reforming the health sector away from curative to preventative health care, through development of outer-island health centers, including civil works and training, and the introduction of user fees of the health facilities and the hospitals. The Project will result in a substantial decrease in overseas' medical referrals, which currently absorb most of the Government's health budget and a reorganization of the financing arrangements in the sector, leading to budgetary savings.

(iii) Majuro Water Supply and Sanitation

44. This Project will rehabilitate the water supply system in Majuro, and ensure long-term sustainability of the Majuro Water Supply Company without Government subsidies. The Project will result in a decrease in Government expenditure and a more favorable environment for human and economic development.

b. Technical Assistance

(i) Institutional Strengthening of OPS

45. The objectives of this TA[1] include the training of suitable counterpart staff and the strengthening of the Office of Planning and Statistics (OPS) capacity in the formulation, monitoring and evaluation of development plans and projects; and the collection, publication and dissemination of socioeconomic data. OPS has played a key role in the formulation of the PSRP, by providing data and information as well as participating in policy dialogue. OPS will play an important role in setting up and implementing the monitoring mechanism for the PSRP.

(ii) Small Enterprise Development

46. This TA[2] was implemented in the first quarter of 1996, and assisted the Ministry of Resources and Development to identify the potentials for small business development, identify the constraints, and formulate a first draft policy for the development of this important sector. The findings of this TA are included in the design of the Retirement-in-Force (RIF) program of the civil service (see para. 55).

(iii) Policy Advisory Team

47. The Policy Advisory Team (PAT)[3] has played a central and proactive role in assisting the Government to design the overall PRP, to formulate the PSRP, and to conduct the policy dialogue with the Bank. The PAT will continue to play this important role, focusing on ensuring effective implementation of the PSRP and making preparations for those reforms that are not included in the PSRP but are part of the overall reform program.

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[1] TA No. 1671-RMI: *Institutional Strengthening of the Office of Planning and Statistics*, for $1.2 million approved on 20 February 1992.

[2] TA No. 2204-RMI: *Small Enterprise Development*, for $0.3 million approved on 23 November 1994

[3] TA No. 2295-RMI: *Policy Advisory Team for Economic Management*, for $2.5 million approved on 31 January 1995.

(iv) National Fisheries Development

48. The objective of the TA[1] is to prepare a national fisheries development plan that will include a profile of the fisheries sector, identifying needs, opportunities, constraints and solutions. The draft Plan is expected to be ready by the first quarter of 1997, and will enable the formulation of growth strategies in one of the two potential sectors for economic development. The TA is supporting the PSRP by providing a sector focus and strategy.

(v) Tourism Development

49. This TA[2] addresses a sector having a substantial growth potential. The aim of the TA is to establish an effective public-private sector institution as the focal point for tourism development in the RMI. The focus is therefore on institution building and training. In addition, the TA will undertake a survey among tour operators in the Asia-Pacific region to assess the potential markets that could be developed. It is expected that the TA will be completed by early 1997, after which a tourism development strategy can be formulated in the first half of 1997.

2. IMF/UNDP

50. IMF carries out its annual Article IV consultations and has provided technical assistance in the past, in regard to studies leading to recommendations on the improvements of the fiscal and taxation issues. It has also financed the position of a banking commissioner. The IMF is a full and active member of the Consultative Group for RMI, and is in full support of the PSRP. UNDP support has concentrated on public sector management improvement, training and small enterprise development.

3. United States

51. Since the Compact of Free Association 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. The main responsibility for assistance to the RMI lies with the Department of Interior, although an estimated 44 US Federal agencies have discretionary programs in the RMI (see para 10-13).

4. Others

52. Japan's assistance amounts to around $2 million annually. A number of high schools have been constructed on Majuro, an outer-island fisheries project has been started and the main road on Majuro is being rehabilitated. The People's Republic of China's assistance has focused on the agriculture sector, through small pilot projects, manufacturing, through a soft loan for a garment factory, and the education sector, where a soft loan has been provided for the construction of a school on Majuro atoll. Australia and New Zealand each have a small program focusing on human development.

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[1] TA No. 2349-RMI: *National Fisheries Development*, for $600,000 approved on 22 June 1995.

[2] TA No. 2483-RMI: *Tourism Development Project*, for $480,000 approved on 19 December 1995.

IV. THE PUBLIC SECTOR REFORM PROGRAM

A. Background

53. The Government has been trying to stimulate economic development and attempting to contain the fiscal deficit for a number of years, but with limited success. More recently, a greater sense of urgency was brought about by a number of factors. Firstly, the fiscal position has become difficult, as most Compact funds have been committed to debt servicing. Secondly, while substantial investments have been made in the past, these have not yielded the desired results in terms of stimulating economic growth or increasing Government revenues. The Government requested Bank technical assistance for designing and implementing the PRP. This assistance started in July 1995, with the fielding of the Policy Advisory Team (PAT)[1]. The Government has shown active interest and willingness to introduce substantial reforms in the economy and in November 1995 adopted the outline PRP. In December 1995, the Bank hosted the first Consultative Group Meeting for the RMI in Manila. At that meeting, the Government presented its outline PRP, which was fully endorsed by the external aid community. A second Consultative Group meetings was held in Manila in October 1996 to review the progress of implementation of the PRP.

54. The PRP broadly contains the following main elements: (i) fiscal stabilization and fiscal policies, (ii) privatization of public sector enterprises, (iii) public service reform, and (iv) a number of measures to stimulate private sector development. The program to stabilize public finances essentially consists of two phases: (i) the adjustment in FY1996 and FY1997 to initiate a response to the Compact step-down that took place in October 1996, and (ii) the longer term adjustment to FY2001 and beyond in order to accommodate the even greater reduction in, or possible termination of, Compact inflows in FY2001. The main contribution to this fiscal adjustment has to be made by, among other measures, reducing public expenditure, reducing the number of civil servants and their pay levels, corporatizing and/or privatizing public entities and authorities, and streamlining Government operations. At the same time, however, an important contribution to fiscal reform should be made by an improved and more efficient tax system.

55. Privatization of public sector enterprises is the second of the four major parts of the PRP. The Government has identified the following goals of privatization: (i) elimination or reduction of subsidies, (ii) provision of a one-off source of revenue, and (iii) re-allocation of resources to enhance productivity and national income. Elimination of subsidies is urgently needed. The Government recognizes that there are different forms of privatization, and indeed, in a number of instances it would be more appropriate to refer to corporatization or commercialization. Government plans for public service reform, an important element of the PRP, are reflected in a Government/United Nations Development Programme (UNDP) report (summarized in Appendix 1), which recommends a restructuring of the Government administration, reducing the number of ministries from ten to six, and reducing the number of civil servants from an estimated 2,200 to below 1,500 through a Retirement-in-Force (RIF) program. The report also included specific measures for (i) improving efficiency, (ii) streamlining administrative structures, (iii) promoting privatization and contracting-out of services, (iv) improving the job grading and salary system, and (v) introducing a better personnel management system.

56. The proposed Government strategy to stimulate private sector growth consists of two elements: (i) removal of the serious distortions which have been hampering economic development, leading to a more efficient resource allocation in the economy; and (ii) introduction of measures which will overcome a number of specific constraints on private sector growth. These include fiscal

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[1] TA 2295-RMI: *Policy Advisory Team*, for $2.5 million approved on 31 January 1995.

measures, civil service reform, business licensing issues, improving the labor market, financial sector development, and secure access to land for development and investment.

B. Overview

57. Based on the PRP, a Public Sector Reform Program (PSRP) has been prepared by the Government in consultation with the Bank. The PSRP has been derived from the PRP on the basis of the following considerations: (i) the RMI is facing a difficult fiscal situation with a possible substantial contraction in GDP in the near future, and substantial cuts in Government spending as well as increased domestic resource mobilization are urgently needed to address this potential crisis; (ii) reforms that the Government is ready to implement now are included in the PSRP; and (iii) to successfully address the impending financial and economic crisis the country is facing, and to fully implement the PRP, a large number of policy actions and reforms in many areas are needed. The implementation capacity of the Government is limited and only those reforms that have a chance of being implemented over the next two to three years, with technical assistance, have been included in the PSRP.

58. The objectives of the PSRP are to (i) stabilize the Government's finances in the short-term, (ii) ensure long-term structural stability of Government's finances, and (iii) create an improved enabling environment for the private sector. While these three objectives are necessary to address the short-term fiscal constraints and create an environment for sustainable growth, they alone are not sufficient to achieve that growth.

59. The scope of the reform program includes three areas: the public service, fiscal policies and the transport sector. The main rationale for the inclusion of these three areas in the PSRP is that all three have a large impact on public sector finances, and reforms in all three are necessary, although not sufficient, to achieve private sector-led economic growth. More specifically, the transport sector has been included for the following reasons: (i) the sector has absorbed an important part of the Government's resources over the last ten years; (ii) the sector will play a key role in the development of a geographically widely dispersed nation; (iii) by reforming the sector, important budgetary savings can be achieved in the short-term, and it can contribute to private sector growth in the medium term.

60. The PSRP has been summarized in a Policy Matrix that takes the form of a logical framework, detailing specific actions, timing and monitoring mechanisms (see Appendix 2). Presented by primary and secondary objectives, the specific policy actions detailed in the Policy Matrix have been put in order of targeted completion date. The PSRP started on 1 January 1996 and ends on 31 December 1998.

C. Program Components

61. The three main Program components are discussed below and further details are presented in Appendix 1.

1. Stabilization of Public Finances

62. The public finance situation is precarious and needs to be addressed urgently. All measures included under this heading are for implementation before the end of 1996. Measures to increase revenues in the short term include a new import duty schedule, an increase in the tax on gasoline, and the appointment of a revenue administration advisor. Measures to reduce expenditures in the short term include the reduction or elimination of operating subsidies for Government-owned corporations, a reduction in wages for the higher wage earners, a nominal wage

freeze for all civil servants, and a 3 percent across-the-board cut in operating budgets of all ministries.

2. Ensure Long-term Structural Stability of Public Finances

63. The measures under this component are aimed at permanently reducing Government expenditures, broadening domestic revenue collection, and preserving or improving management of separate funds under Government control. Despite the high level of uncertainty regarding US assistance after 2001, all measures combined will not be sufficient for achieving long-term stability; further adjustments will be necessary in the years to come.

64. Measures for the structural improvement of public finances are to be implemented before the end of FY1997. There are three objectives: (i) reduce recurrent Government expenditure by 20 percent, (ii) improve and broaden domestic revenue collection, and (iii) establish funds and/or continue sound management of funds under control of the Government. The measures include: (i) amalgamation of the functions of the Ministry of Social Services with other ministries, (ii) freezing of nominal wages for a three-year period, (iii) merging of the Ministries of Resources and Development and Public Works, (iv) abolishment of the Shipping Corporation, (v) permanently reducing the size of the civil service, (vi) establishing the MIVA as an independent and self-financing entity, (vii) reviewing the operational budgets of all ministries, and (viii) ending operational subsidies to AMI.

65. To improve domestic revenue collection, the tax administration needs to be reorganized. To broaden the revenue base, and at the same time introduce a non-discriminatory tax to stimulate private sector development, a system of value added tax (VAT) and excise duties will be introduced. The introduction needs to be prepared and executed carefully, with the reorganization and strengthening of the tax administration being only the first but necessary step. Domestic revenue collection will be further broadened by increasing the degree of cost recovery in the road transport subsector. The Government will also establish a Financial Reserves Trust Fund (FRTF) to allow it to build up a prudent level of financial reserves for the future.

66. A key element is the reform and downsizing of the civil service. The civil service reform program was produced as a joint effort between the Government and UNDP, and the final report was presented in December 1995. In this context, the main concern was to create a civil service that is more affordable than the existing service. The program focuses on (i) the need to reduce costs where possible, and on an ongoing basis; (ii) the need to produce a simple, rational, and easily understood system; and (iii) the need to produce a structure geared toward achieving the Government's objectives, both economic and social.

67. The size of the civil service was estimated at 2,200 as of December 1995. The report recommends reduction of the number of civil servants to 1,480 and the number of ministries from ten to six, and reorganization of various administrative functions. The report also contains a number of recommendations to improve personnel management. The Government has started to implement the recommendations of the report. The question of how best to deal with staff who become surplus to requirements during the downsizing process has been of concern to the Government. It is acknowledged that the state of the economy is such that it is unlikely that the private sector will be able to immediately absorb many of the public servants who may be retrenched. It has been concluded that the most constructive approach is by way of making reasonable severance payments to the employees affected.

68. The Government has opted for a severance payment scheme which consists of two major parts. One is a lump-sum payment, equivalent to three to nine months of salary, depending on

the length of service. The second is intended as a form of social safety net, and will consist of a monthly maintenance benefit to be paid over a period of three years. Persons that will find a new job within this period will lose their benefit entitlement. In addition, the Government will provide training and counseling services; this is supplemented by a UNDP-funded program for small business training.

69. Based on salaries paid in the civil service (which range from $4,000 to $10,000 per year and average $7,000) and average length of service, it is estimated that an average of four months of salary will be paid as lump-sum, at a total cost of $1.75 million. The maintenance benefit would be paid out on the basis of the current benefit rules of the Marshall Islands Social Security Administration (MISSA), amounting to a payment of $175-$245 per month,[1] and at a total cost of around $1 million per year. Taking into account considerable uncertainties regarding the structure of the group to be included in the RIF program, it has been estimated that the RIF (including training and counseling) will cost $3 million in the first year and $1 million in each of the two following years.

3. Creation of a More Enabling Environment for the Private Sector

70. The creation of a more enabling environment for private sector development has many dimensions, including the reduction of the absorption of resources by the Government, the reduction of the influence of the Government on factor prices, making land available as a reliable factor of production, the creation of a transparent regulatory environment and the implementation of clear sector strategies.

71. The Government's absorption of resources in the economy is a result of its relatively high wage bill, in addition to high levels of other recurrent and capital spending. Part of this problem in being addressed through the PSRP, which will reduce the absolute size of the Government, and thereby recurrent spending, as well as reduce the wage bill through the RIF program. In addition, it is necessary to remove the upward pressure of public sector wages on private sector wages.

72. Some form of privatization of many of the Government's agencies and corporations is required to free up the economy and improve the impact of market forces to replace bureaucratic decision-making. In the absence of a detailed strategy for privatization and in the absence of a capital market, this will take some time to develop. In the short term, three types of actions can be taken. First, the reorganization of the Government's administration, to make it smaller, more transparent, more efficient, and concentrated on its core activities. Second, the appointment of new boards of directors for various Government agencies or corporations to ensure private sector majority and to lessen bureaucratic decision-making will be implemented. Third, a Private Sector Unit will be established to draw up a privatization strategy and implement it.

73. The remoteness of the RMI, the small size and scattered nature of its population, and the low level of domestic economic activity, present formidable challenges to the development of the country, and to the operation of its transport sector. Both domestic and international transport services involve low volumes of traffic over long distances, and these characteristics combine with the high fixed costs and "lumpiness" of transport infrastructure investment to keep unit costs high, even if only minimum technical standards are used. Thin flows of goods and passengers also limit the frequency of services and, in turn, provide a disincentive to production, thus reinforcing the low demand for transport and its high cost. As a consequence, many of the outer atolls cannot be serviced on a profitable basis, even though the Government regards it as a social imperative to

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[1] The Government believes that this amount is sufficient as a minimum social safety net, while too low to create any dependency on this income. The compensation package as a whole is more generous than the one the Cook Islands Government opted for (where the retrenched civil servants have the option of the New Zealand social security system), and less generous than the one in FSM.

maintain at least a minimum service. The Government has decided that the transport sector should be run on commercial lines, with any subsidies considered as unavoidable on social grounds being shown as explicit line items in the budget.

74. This has not occurred hitherto. Several Government agencies and special purpose authorities share responsibility for the transport sector, particularly in the areas of shipping, ports and airports while several Government agencies are also involved in the maintenance of transport infrastructure. Virtually without exception, these various agencies have been operated inefficiently and expensively, with financial losses suffered by transport operations alone totaling over $7 million in FY1995, or 9 percent of GDP, with AMI leading the loss-making ventures. The ease with which budgetary support has been obtained in the past has created an environment for the almost open-ended subsidization of transport operations.

75. The focus of the PSRP, as of the Bank's strategy for the transport sector in the Pacific region, is on increasing efficiency and improving service rather than on expanding capacity. With its basic premise that of encouraging the sector to be self-financing, the PSRP aims to rejuvenate RMI's transport sector by promoting policy reforms and sector restructuring so as to create the environment necessary for efficient and sustainable infrastructure provision, and for the mobilization of the resources needed for future infrastructure development. Emphasis is thus placed on managerial improvements, cost recovery, tariffs and regulations to foster growth, resource mobilization, and competition. A fundamental provision of the PSRP, therefore, is the corporatization of the agencies operating transport services and, where appropriate, their privatization. This will separate the provision of transport services from the budget, introduce greater financial discipline and the efficiency it inculcates, and raise the quality of service provided. If any loss-making services have to continue to be provided, such as certain services—including emergency services—to the outer islands, they will be financed by explicit subsidy to the agency concerned.

D. Expected Impact

76. The PSRP recognizes explicitly that Government expenditure has to become more closely related to the revenue that can be raised domestically, and that the economic future of the RMI depends heavily on the development of private initiative and to a reduction in the pervasiveness of Government. Thus, while immediate gains are expected to arise from removing various economic distortions and from reallocating resources, it is the anticipated long-term gains that are potentially of greatest importance. The medium-term projected impacts of the PSRP on the Government's finances are shown in Table 3, below.

77. While the long-term impact of the PSRP on growth, employment and efficiency may be expected to be beneficial, there will inevitably be transitional dislocations that could extend to some years. The most immediate and socially difficult of such dislocations will arise from the planned contraction in the size of the public service which, given the number of dependents typically reliant on the income of a Government employee in the RMI and the significance of public servants as a component of aggregate demand, will cause social distress. Moreover, in the RMI where the scope for falling back on subsistence agriculture in the event of need is limited, many more than the retrenched public servants themselves are likely to be adversely affected. The tax increases and improved tax collection machinery anticipated as part of the PSRP will also serve to reduce disposable income over the short to medium term and to contribute to a cut in consumption. Thus, the PSRP will have significant social and economic implications. No significant adverse environmental impacts are expected to occur as a result of the PSRP.

Table 3. Projected Government finances through FY2001

Item	FY1995 Actuals	FY1996 Est.	FY1997 Proj.	FY1998 Proj.	FY1999 Proj.	FY2000 Proj.	FY2001 Proj.
Revenues and grants	77.8	77.6	63.2	61.4	59.4	56.2	54.4
Tax revenue	19.9	19.4	16.8	15.1	15.3	13.7	13.1
Nontax revenue	15.4	11.1	7.5	6.2	5.2	4.8	4.6
Grants	42.5	47.1	38.9	40.1	38.9	37.8	36.7
Expenditure	100.4	75.3	65.2	50.4	48.8	41.2	33.7
Current expenditure	58.7	53.7	50.9	45.0	42.9	35.1	33.3
Wages and salaries	21.9	20.7	18.8	16.9	16.4	16.0	15.5
Goods and services	20.0	20.0	18.1	16.4	15.9	15.4	15.0
Program loan disbursements	-	-	2.9	2.8	3.7	0.0	0.0
Interest	7.5	7.7	6.5	5.2	4.0	2.7	2.7
Subsidies and transfers	9.3	5.3	4.7	3.6	2.9	1.0	0.9
Capital expenditure	41.6	21.7	14.3	5.4	6.0	6.1	0.4
Overall balance	-22.6	22.2	-2.0	10.9	10.5	15.1	20.7
Financing	22.6	-2.2	2.0	-10.9	-10.5	-15.1	-20.7
Net borrowing	-13.4	-13.1	-9.5	-10.9	-10.5	-15.1	-20.7
Gross borrowing	0.0	0.0	7.1	6.6	7.3	3.6	3.5
Repayments	-16.2	-16.4	-16.6	-17.5	-17.8	-18.6	-24.2
Use of liquid assets	36.0	10.9	11.7	0.0	0.0	0.0	0.0
Unreserved financial holdings	-0.3	-1.4	-1.4	-1.3	-1.3	-1.3	-1.2

Source: Government of RMI, Policy Advisory Team

78. On the other hand, the social and economic effects that are likely to result either from failing to introduce reforms immediately, or from implementing them without the external support that is proposed, would be even more severe. Three scenarios have been examined to determine the possible socioeconomic impact of various policy options: (i) where no significant reforms are implemented by the Government, (ii) where the Government attempts to implement the proposed reform program but has to do so without external financial and technical assistance, and (iii) where the PSRP is fully implemented and supported by external assistance. Poverty impact matrices for these scenarios are presented in Appendix 4, while a more in-depth social impact assessment is in Appendix D.

79. Not introducing reforms now would have no immediate impact on the poor or nonpoor either through changes in personal consumption patterns or the demand for labor or, therefore, via secondary multiplier effects. However, inaction now would inevitably result in fiscal collapse over the near term because current fiscal trends are unsustainable. This would have profound consequences, and it would force in its wake even more abrupt salary reductions and layoffs in the civil service — possibly of a greater magnitude also — than are being proposed under the PSRP. This would then have income and consumption effects elsewhere in the economy, via the income/employment multiplier. This would almost certainly be aggravated by the Government's likely enforced inability to pay its bills or to provide the necessary public goods and services. The economic instability that would result would also have serious implications for private sector confidence and would serve to reduce the demand for labor, thus prolonging recession and delaying recovery. Moreover, while these effects would inevitably affect both poor and non-poor, they would doubtless impinge most severely on the poor, both directly and indirectly.

80. Similarly, trying to implement the PSRP without the maintenance payments, which act as a social safety net, would place the initial burden of national adjustment on a relative few, and provide them no form of assistance to adapt to their changed circumstances. Retrenchment without compensation, especially when combined with the degree of tax reform that is envisaged, would have a significant negative effect on consumption patterns. The recessionary conditions thus caused

would reverberate throughout the economy, and reduce the demand for unskilled labor in some respects similar to the previous scenario. It would almost certainly impact most severely on the poor, as well as run the risk of creating a class of new poor. Thus, a significant loss of welfare would be felt by those individuals initially retrenched (as well as by their dependent extended families) if there were no financial assistance given to them in the interim, and recovery — both individual and national — would be delayed if they were also to be denied access to the counseling and training facilities that would prepare them for new circumstances and employment.

81. The third scenario, viz., implementing the reform program with external assistance, would also lead to a loss of welfare caused by retrenchment and tax reform, but it would be mitigated initially by compensation payments that would serve to underpin effective demand, to temper personal hardship, and to moderate the depth of potential economic recession. Moreover, the counseling and training to be provided under the PSRP would assist those affected in seeking alternative employment and, by so doing, serve to absorb the unemployed and to kindle national economic recovery. Subsequently, and partly concurrently, tax reform should contribute to sustained macroeconomic stability and to rejuvenated public services.

82. Technical assistance will be provided for the development of a sound implementation plan for civil service reform, and in particular for a detailed RIF-program, to ensure that it will be nondiscriminatory, against either the poor or the women.

V. PROPOSED BANK ASSISTANCE

A. Objectives

83. The main objective of the proposed Bank assistance is to help the Government in implementing the PSRP, through the provision of a loan to help meet the costs of reform, and through the provision of technical assistance for Program implementation. Specifically, the objectives of the financial assistance are (i) to moderate the immediate social impact of civil service retrenchment; (ii) to contribute to revenue growth and expenditure reduction, and thus to short-term fiscal recovery and long-term fiscal stabilization; and (iii) by removing some of the market distortions that exist, contribute to the creation of an enabling environment for private investment as the base for greater self-reliance. The objective of the technical assistance is to ensure timely implementation of the various reforms under the PSRP.

B. Bank Loan

1. Amount of Loan and Source of Funds

84. It is proposed that the Bank provide a loan of $12 million equivalent from its Special Funds resources to support the Government's Public Sector Reform Program. The loan amount is based on the scope and the costs of the policy reforms, the importance and urgency of the reforms, and the critical state of public finances.

2. Interest, Maturity, and Utilization Period

85. The loan will have a repayment period of 40 years, including a grace period of 10 years, and carry a service charge on the amounts disbursed of 1 percent per annum. The loan is expected to be utilized over an 18 month period and funds will be released in three tranches.

3. Implementation Arrangements

86. The Ministry of Finance will be the Executing Agency for the PSRP and will have the overall responsibility for its implementation. The Government has appointed a Rationalization Committee, headed by the Chief Secretary, that will coordinate the implementation of the PSRP. The Social Security Fund will be responsible for the administration of the benefits to be paid under the RIF program.

4. Disbursement

87. Disbursement will take place against submission of documentation acceptable to the Bank relating to imports of any goods other than those included in a negative list. To be eligible, imports must be produced in and procured from the Bank's member countries.

5. Counterpart funds

88. To meet the objectives of the loan, the funds disbursed and at the disposal of the Government (the counterpart funds) will be utilized, first, to provide modest financial and human resource development support for persons retrenched from the public service (the RIF program), thereby moderating not only their own and their families' financial hardship, but also that of the tradespeople who rely on their continuing business. Secondly, the funds will make a contribution towards the retirement of the Government's debt, particularly the portion of the debt incurred on the least favorable conditions, i.e., short-term debt carrying high interest rates. In the context of AMI's ongoing restructuring, the Government had no other option but to borrow at such terms in order to restore AMI's working capital to an operationally desirable level. Thirdly, the establishment of the Financial Reserves Trust Fund would eliminate a source of cash flow uncertainty and generate a potential new source of investment income (the latter similar to that of Tuvalu)[1].

6. Monitoring and Tranching

89. The funds will be released in three tranches, to match the disbursement schedule for the RIF program, a key reform, and to enable close monitoring of the implementation of the PSRP. On a continuing basis, the Government and the Bank will review the implementation of the PSRP. Its progress will be reviewed by the Bank in consultation with the Government during the third quarter of 1997 prior to the second tranche release. The third tranche will be released within a year from the second tranche, and upon the Bank being satisfied that the conditions for its release have been fulfilled.

90. The monitoring mechanisms for second and third tranches are the approved budget for FY1998 (starting 1 October 1997) and Government reporting and Bank monitoring missions. In this regard, the Government has agreed to provide relevant data and information in such detail as the Bank may reasonably request. The social and economic impact of the PSRP will be monitored by OPS through a monitoring system to be developed with technical assistance from UNDP. Special attention will be paid to the monitoring of private sector development, including such indicators as private investment, employment and informal sector activities.

91. The proposed amounts to be disbursed for each of the three areas of utilization, and for each tranche are as follows:

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[1] The Tuvalu Trust Fund was established with external financial assistance to build up a financial reserve for the country.

Table 4: Program Loan Tranching Schedule (millions of US dollars)

Item	Loan Effectiveness	2nd tranche	3rd tranche	Total
Financing of the RIF program	3.5	1.0	1.0	5.5
Debt servicing of AMI	2.0	2.0		4.0
Financial Reserves Trust Fund		0.5	2.0	2.5
TOTAL	5.5	3.5	3.0	12.0

C. Technical Assistance

92. The Government has requested advisory TA for the implementation of the PSRP and its various components. The provision of such TA is critical to the PSRP, considering the limited implementation capacity of the Government. In view of the urgent need to implement the reforms, there is little time and opportunity for capacity building to provide the Government with the necessary skills to implement the reforms. Rather, the reforms need to be implemented so as to create an administration that will have the capacity to manage the country more efficiently, and will be capable of implementing the next round of reforms. TA requirements for the implementation are outlined below. Details are provided in Appendix 3.

1. Program Coordinator

93. In recognition of the limited implementation capacity of the Government, and as the PSRP needs to be implemented on an urgent basis, a Program Coordinator will be appointed for a period of two years to assist the Government in managing and implementing the PSRP.

2. Institutional Strengthening in the Transport Sector

94. Technical assistance will be provided to assist in the operationalization of the Marshall Islands Ports Authority, the establishment of the Marshall Islands Airport Authority, and the revision of road user charges to improve cost recovery. It is estimated that a total of 15 person-months would be required.

3. Support of the Private Sector Unit

95. Technical assistance will be provided for the establishment of a Private Sector Unit in the Office of the President. The purpose of the unit would be to assist the Government to privatize, in whatever form or manner, many of its agencies and corporations. The unit would first of all establish guiding principles and methods for privatization, and then assess each potential candidate as to the most suitable method of privatization. Through specialized short-term consulting services, the plans would then be implemented. The TA will also provide a framework for private sector regulation. It is estimated that the TA would require 18 months of mainly short-term inputs.

VI. PROGRAM JUSTIFICATION AND RISKS

A. Program Justification

96. Fiscal adjustment is inevitable in the RMI, whether it be introduced by the Government in an explicit attempt to reform or imposed by financial realities; it is only its timing and its nature that are in part amenable to organization and management. Unassisted, the Government does not have

adequate resources of its own to undertake the required reforms. The significant policy measures to be undertaken as part of the PRP in order to underpin the reform process, the commitment of the Government to the PRP, and the anticipated longer term benefits of the PRP, together provide adequate justification for the Bank to provide assistance to meet part of the adjustment costs. The Government has already incurred costs in executing past reforms, and substantial costs will be incurred in the future as the PRP is implemented.

97. In this context, the purpose of the proposed program loan, and of the reforms on which it is conditional, is threefold: (i) to moderate the immediate domestic social impact of civil service retrenchment; (ii) to contribute to revenue growth and expenditure reduction, and thus to short-term fiscal recovery and long-term fiscal stabilization; and (iii) by removing many of the market distortions that exist, to create an enabling environment for private investment and the base for greater self-reliance.

98. To these ends, therefore, the disbursement pattern adopted under the proposed loan seeks, first, to provide modest financial support for three years for those people actually retrenched from the public service, thereby moderating not only their own and their families' financial hardship, but also that of their creditors and of the tradespeople who rely on their continuing custom. Secondly, by supporting the retirement of AMI's accumulated commercial debt, a source of the Government's ongoing fiscal deficit would be removed. Notwithstanding implementation of an action plan for AMI's long-term recovery, the debt issue would need to be addressed prior to the implementation of the recovery program. Thirdly, by supporting the creation of a Trust Fund, a source of cash flow uncertainty would be eliminated and a potential new source of investment income generated. Underpinning this basic disbursement pattern, moreover, is a policy matrix which caters to both short-term and longer-term adjustment needs and lays the groundwork for a more self-reliant economy, albeit one with domestic income levels that are lower than at present.

B. Program Risks

99. The principal risks are that (i) the Government's capacity to effectively implement reforms may prove to be insufficient, (ii) the Government's commitment to the current pace of reform may not continue, as the retrenchment of a large number of civil servants may fuel strong opposition to reforms, and (iii) the private sector may not respond as expected. Each of these three risks have been addressed, within as well as outside the PSRP. As a part of the PSRP, TA will be provided for a Program Coordinator to ensure that timely and coordinated action will be taken on the various components of the PSRP. In addition, the ongoing Bank-financed PAT project will continue to assist the Government in this regard. While capacity building has proven to be difficult in the Marshall Islands in the medium term, capacity building in policy formulation and implementation will continue to receive priority.

100. The Government's commitment to reform is very strong at present, as witnessed by the fact that many civil servants have already received their notice of termination. With any retrenchment program, there is a risk that opposition may emerge. By acting quickly and decisively, the Government has prevented some of the potential opposition. The maintenance payments should also be viewed in this perspective.

101. Risks are also associated with the capacity of the private sector to respond to the improved environment. These risks are being addressed with a number of initiatives. Firstly, the improvement of the macroeconomic environment for the private sector is being complemented with specific sector strategies for fisheries and tourism, the two sectors with most potential for economic growth. Secondly, the Bank is investigating ways of making medium and long-term credit available to the private sector. Thirdly, the UNDP is assisting with a program to encourage and train small

entrepreneurs. The future of the RMI appears to depend heavily on a large number of small commercial and/or subsistence activities rather than on paid employment in large enterprises.

102. Extensive discussions and widespread consultations have sought to broader the support for the PSRP. The measures and targets included in the PSRP have been carefully assessed and selected to ensure their prima facie feasibility as well as to secure the Government's commitment to their introduction. Moreover, the tranching features of the proposed disbursement schedule provide incentives to the Government to meet its commitments under the PSRP, while at the same time providing the Bank with measurable indicators of progress.

VII. ASSURANCES

103. The Government has given the assurance that it will continue to implement the reform program, as reflected in its Development Policy Letter (see Appendix 2). It has also been agreed that the Government and the Bank will continue their policy dialogue on problems and constraints encountered during implementation of the PSRP. The Government has also assured that it will keep the Bank informed of policy discussions concerning the PSRP undertaken with other international and bilateral agencies as the Bank may reasonably request, and shall provide the Bank with the opportunity to comment on any resulting policy proposals.

A. Counterpart Funds

104. The Borrower will ensure that the Counterpart Funds withdrawn from the Special Account to be established for the purpose of the loan, will be used for (i) financial support for civil servants retrenched from the public service under the RIF program, (ii) supporting retirement of AMI's accumulated commercial debts, and (iii) supporting the establishment of the Financial Reserves Trust Fund.

B. Monitoring and Evaluation

105. The Bank will monitor closely the implementation and impact of the Program, including future policy, institutional and financial developments, and any other changes likely to have an effect on the Program. The Office of Planning and Statistics will be charged with the design and implementation of a monitoring program.

C. Air Marshall Islands

106. The Government has assured that AMI will be managed as a commercial concern, in accordance with internationally accepted commercial management practices, and that the AMI Board of Directors will consist of five members only, at least two of which will be from the private sector. The Chief Executive Officer of the airline will continue to be an internationally experienced and competent airline manager. The Government will also ensure, through contractual arrangements satisfactory to the Bank, that the management of AMI has clear delegated powers and adequate resources, to manage the airline on a strictly professional basis. The Government will forward to the Bank on a monthly basis, operational, and financial statements of AMI.

VIII. RECOMMENDATION

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

(i) the loan in various currencies equivalent to Special Drawing Rights 8,241,000 to the Republic of the Marshall Islands for the Public Sector Reform Program, with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board; and

(ii) the provision of technical assistance, on a grant basis, in an amount not exceeding the equivalent of $760,000 to the Government of the Republic of the Marshall Islands for Support of the Private Sector Unit.

MITSUO SATO
President

16 December 1996

APPENDIXES

Number	Title	Page	Cited On (Page, para.)
1.	Program Description	25	12,55 13,61
2.	Development Policy Letter and Policy Matrix	32	13,60 22,103
3.	Proposed Technical Assistance for Program Implementation	46	20,92
4.	Poverty Impact Assessment	58	17,78

SUPPLEMENTARY APPENDIXES

A. Summary of Compact Agreement (available upon request)

B. Summary of Taxation Issues (available upon request)

C. The Transport Sector (available upon request)

D. Social Impact Assessment (available upon request)

PROGRAM DESCRIPTION

A. Overview

1. The Public Sector Reform Program (PSRP) of the Government of the Republic of the Marshall Islands (RMI) is an integral part of the Government's Policy Reform Program (PRP) presented to the external aid community during a Bank-organized Consultative Group meeting, in Manila in December 1995. The PRP has the following main elements: (i) fiscal stabilization and tax reform, (ii) privatization of public sector enterprises, (iii) public service reform, and (iv) promotion of private sector development.

2. The PSRP has been derived from the PRP on the basis of the following considerations: (i) the RMI is facing a difficult fiscal situation with a possible substantial contraction in GDP in the near future, and substantial cuts in Government spending as well as increased domestic resource mobilization are urgently needed to address this potential crisis; (ii) reforms that the Government is ready to implement now are included in the PSRP; and (iii) to successfully address the impending financial and economic crisis the country is facing, and to fully implement the PRP, a large number of policy actions and reforms in many areas are needed. The implementation capacity of the Government is limited and only those reforms that have a chance of being implemented over the next two to three years, with technical assistance, have been included in the PSRP.

3. The overriding objective of the PSRP is to stabilize public finances and to initiate reform of the public sector. To achieve this, there are three primary objectives: (i) to stabilize the Government's finances in the short-term, (ii) to ensure long-term structural stability of the Government's finances, and (iii) to create an improved enabling environment for the private sector. While these three primary objectives are necessary to address the short-term fiscal constraints and create an environment for sustainable growth, these objectives alone are not sufficient to achieve that growth. The PSRP therefore is a program with a limited focus designed to create a stable macroeconomic framework which will contribute to the overriding objective of the creation of an improved enabling environment for private sector-led economic growth.

4. To attain these objectives, reforms are included in three areas: the public service, fiscal policies and the transport sector. The main rationale for the inclusion of these three areas in the PSRP is that all three have a large impact on public sector finances, and reforms in all three are necessary to achieve private sector-led economic growth.

B. Stabilization of Public Finances

5. The goal of stabilization of Government finances was achieved by the beginning of FY 1997, on 1 October 1996. This was done by increasing revenues, and reducing expenditures. To increase revenues, actions have been formulated that will result in improved implementation of the Revenue Act. There are no data available on collection efficiency, but it is considered that substantial revenues due to the Government have not been collected because of weaknesses in the organization of the Revenue Division of the Ministry of Finance. The Bank has recommended, and the Government has agreed that an expatriate Chief of the Revenue Division be recruited urgently to focus on institution building and training.

6. Measures that have already been taken include the appointment of a tax auditor for a period of three months[1], to assess the status of tax arrears, the doubling of the tax on gasoline, the introduction of a simplified import duty schedule and increased revenue collection by targeting the arrears.

7. A reduction in Government expenditures is the key to stabilizing public finances. Cuts have been made in wages and salaries, operating expenditures and subsidies to avert a serious cash flow problem in 1996 and beyond. As part of the March 1996 interim budget, all ministries have been instructed to reduce operating expenditures by 3 percent. Other measures in that budget included a reduction in, or elimination of, a number of subsidies and the retrenchment of 180 staff from the Ministry of Social Services.

C. Structural Improvement of Public Finances

8. Measures for the structural improvement of public finances are to be implemented before the end of FY1997. There are three secondary objectives: (i) reduce recurrent Government expenditure by 20 percent on a permanent basis, (ii) improve and broaden domestic revenue collection, and (iii) establish funds and/or continue sound management of funds under the control of the Government.

9. The functions of the Ministry of Social Services were amalgamated with other ministries, while the Ministries of Resources and Development and of Public Works were merged. Nominal wages in the civil service have been frozen for a period of three years and the number of civil servants reduced to 1,650, down from over 2,100 a year ago. The Shipping Corporation was abolished. Further plans include the establishment of the Marshall Islands Visitors Authority as an independent and self-financing entity, a review of the shipping privatization procedures, a further reduction in the size of the civil service to 1480, a review of the operational budgets of all ministries, and an ending of subsidies to Air Marshall Islands[2].

10. To improve domestic revenue collection, the tax administration needs to be reorganized, including computerization of the divisions concerned. To broaden the revenue base, and at the same time introduce a nondiscriminatory tax to stimulate private sector development, a Value Added Tax (VAT) and excise duties will be introduced. However, the introduction needs to be prepared and executed carefully, with the reorganization and strengthening of tax administration being only the first but necessary step. Domestic revenue collection will be further broadened by increasing the degree of cost recovery in the road transport subsector. Studies have been completed on the reorganization of the revenue administration and on the feasibility of introducing VAT. The Revenue Division will be reorganized and computerized, while a tax will be introduced on the earnings from the leasing or rental of commercial property. Cost recovery from road users will be increased.

11. Funds under control of the Government include the Marshall Islands Pension Fund (MIPF), which is administrated by Marshall Islands Social Security Administration (MISSA), and two new funds, the Road Trust Fund, to ensure adequate maintenance funds, and the Financial Reserves Trust Fund (FRTF) to build up a prudent level of financial reserves for the future. The preservation of the integrity of the pension fund is essential for the success of the reform program and the implementation of the Retirement-in-Force (RIF) program. To

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[1] The auditor was provided by the Australian Executive Services Overseas Program.

[2] The Government will continue to service the commercial debt on two of its aircrafts used on domestic routes

improve the management of the Fund, a new Board was appointed with majority private sector representation.

D. Creation of a More Enabling Environment for the Private Sector

12. The creation of a more enabling environment for private sector development has many dimensions, including the reduction of utilization of resources by the Government, reduction of the influence of the Government on factor prices, making land available as a reliable factor of production, creation of a transparent regulatory environment, and implementation of clear sector strategies. The Government's utilization of resources in the economy is foremost a result of its relatively high wage bill, in addition to high levels of other recurrent and capital spending. Part of this problem will be addressed by the PSRP, which will reduce the absolute size of the Government, and thereby recurrent spending, as well as reduce the wage bill through the RIF.

13. An important step in the creation of a more enabling environment is to reduce the Government's involvement in the management of various agencies and corporations and to start reducing the Government's utilization of resources in the economy to make room for private sector initiative. Some form of privatization of the Government's many agencies and corporations is required to free the economy and improve the impact of market forces to replace bureaucratic decision-making. In the absence of a detailed strategy for privatization and in the absence of a capital market, this will take some time to develop. In the short run, three types of actions can be taken. First, the Government's administration can be reorganized, to make it smaller, more transparent, more efficient and focused on its core activities. Second, new boards of directors of various Government agencies or corporations need to be appointed to ensure private sector majority and to lessen bureaucratic decision-making. Third, a Private Sector Unit should be established to draw up a strategy and implement it.

14. As part of the reform plans for AMI, the Government appointed a professional and experienced airline interim-manager with the full mandate from the Board to reorganize the company and review its operations in order to end its losses. The manager has reorganized the company, renegotiated contracts, revised domestic fares and retrenched more than 50 of its 120 staff. Negotiations have been completed to pursue a least-cost option to terminate the lease contract for the DC-8 aircraft. The airline is now seeking a permanent Chief Executive Officer who will be a professional and experienced airline manager, with a remuneration package in accordance with international standards. The objective is to manage the airline on a purely commercial basis. It is also the Government's intention to provide AMI management with clear delegated powers to manage the airline, including tariffs, flight schedules and personnel matters, with Board decisions only to be taken on strategic matters. The delegated powers of the management will be contractually agreed upon.

15. A comparative study of private sector and public sector wages to be undertaken by the Office of Planning and Statistics will be completed by July 1997, and a methodology for regular monitoring will be established. The outcome of the study and the monitoring would support future decisions on public service wage reductions.

16. The regulatory environment in the RMI is currently nontransparent with many discretionary powers vested with the executive branch of the Government. This environment needs to be made more transparent and decision-making more automatic and less arbitrary. A number of measures are expected. The registration of companies is currently the responsibility

of Cabinet. To ensure fair and transparent treatment of all companies, registration will be transferred to the Registrar of Corporations, which will register companies according to a standard set of rules. The policy and procedures for employment of non-citizens will be reviewed and changed as agreed upon between the Government and the Bank, to ensure that the requirements for the issuance of managerial and technical work permits will become more transparent, automatic and streamlined.

17. The conditions for obtaining business licenses will be made explicit and transparent to provide for a maximum degree of automaticity and simplicity in acquiring a license and to minimize the discretionary decision-making role of public and elected officials. The Government will guarantee protection of foreign investment to international standards and will introduce appropriate national legislation. The Government will also establish the Office of the Ombudsman, to ensure independent arbitration between the Government and the public at large, with procedures and powers to be agreed upon between the Government and the Bank.

18. The Government will further introduce appropriate legislation and procedures to guarantee legal security of land leases as well as peaceful enjoyment of the right of occupancy under the lease, while ensuring that all customary owners concerned receive a return on land leased commensurate with market conditions, and as agreed upon between the Government and the Bank.

E. The Civil Service Reform Program

1. Introduction

19. The civil service reform program was designed as a joint effort between the Government and UNDP, and the final report was presented in December 1995. The report was mainly concerned with the rationalization and reorganization of the public service. The report was developed over an extended period by the Government, with support from UNDP. The final report was adopted by Cabinet and Parliament in January 1996.

20. The rationalization of the public service in the RMI has been a matter of continuing concern. The first formal move to address issues of public service rationalization was undertaken in 1988, and a succession of study groups have been convened since. However, steps identified over the years to control the public service have not been effective. In 1989, a freeze on hiring was introduced, but this did not produce the desired results; from an estimated total of 1,750 public service employees in 1988, the public service increased to over 2,200 in 1995.

21. A Presidential Committee on the Rationalization of the Public Service was established in October 1992. The Committee was charged with the responsibility of undertaking a thorough review of the entire public service, with a view to identifying short- and medium-term measures for lowering the cost and increasing the efficiency of the public service. In its final report of July 1993, the Committee summarized the major deficiencies in the public service as follows: (i) an overstaffed public service, (ii) inefficient delivery of public services, (iii) a large number of unproductive employees, (iv) a serious shortage of technically qualified staff, (v) organizational structures that were excessively fragmented and tiered, and (vi) widespread functional duplication among units.

22. The final report of the Committee presented detailed proposals for the implementation of a short-term strategy and suggested a medium-term strategy that was

designed to advance the rationalization process further. Specific measures recommended included: (i) improving public service efficiency, (ii) streamlining administrative structures, (iii) promoting privatization and contracting-out of services, (iv) reducing the number of non-technical support staff, and (v) cost containment through reductions in average personnel costs.

23. In January 1994, as a joint effort of the RMI and UNDP, a project was started that led to the civil service reform program. The report set out to strengthen the Government's capacity in economic and social policy analysis and decision-making and in implementing development activities within the public service. The final report proposed a comprehensive restructuring of the public service to enable it to contribute most effectively to the long-term goals of the Government. The report forms the basis for the current public service reforms being undertaken by the Government.

2. Summary of the Program

24. The public service exists to give policy advice to the Government, to carry out government decisions, and deliver services on behalf of Government. Taken together, these three functions basically determine the size of the public service. Of the three, the last—delivery of services—is the most demanding on human and financial resources. The Government's determination to cutback the size of the public service will depend on its willingness to decide on the parameters of its core business and avoid those activities that do not fit within those boundaries. This process needs to be continuous, with the Government and its advisors continually on the alert to identify functions that should be divested or not embarked upon in the first place.

25. At the same time, the public service should not just be seen as a drain on Government resources that needs to be continually cut down to size. From an economic point of view, it should have a very positive role to play in furthering the Government's objectives by, for example, helping to identify trade and investment opportunities, and encouraging the private sector to interest itself in entrepreneurial and export activities. It is essential that the public service be a quality organization, with well-qualified, impartial and committed staff who see their task as service for the welfare of the Government and the country.

26. The Government's objectives and priorities were taken into account in the suggested restructuring and revising of the statements of the roles of the various ministries. These included: the imperative need to search for overseas trade and investment opportunities; the need to avoid duplication between some services provided by the Ministries of Health, Social Services, and Resources and Development; the need to continue the process of devolving responsibilities from Central Government to local government including the outer islands, together with the need to provide within the Central Government machinery a strong voice for local government interests; and the priority to be given to the continuing development of Marshallese cultural affairs.

27. The factors considered in civil service reform included: (i) the need to reduce costs where possible on an ongoing basis; (ii) the need to produce a simple, rational, and easily understood system; and (iii) the need to produce a structure geared toward achieving the Government's objectives, both economic and social. The Government's objectives and priorities were an important part of the exercise. The main recommendations included the reduction of the number of ministries from ten to six, the abolishment of all operating subsidies

to public agencies and the privatization of a number of them, improved personnel policies, and an enhanced role for a central personnel agency.

3. Downsizing of the Public Service

28. It is widely recognized that the size of the civil service, at over 2,200 staff, is too large and should be reduced considerably. A similar conclusion was reached in 1988, when the civil service was considerably smaller. There is no guiding principle as to what constitutes the ideal size of the civil service, in terms of numbers per population, or in terms of services to be delivered. Instead, the main concern of the Government/UNDP report is to create a civil service that is more affordable than the existing one. The issue of what is affordable is difficult to address, in the light of the considerable uncertainties in RMI's future.

29. The decision on the extent of downsizing was made more difficult in the absence of any reliable data on the actual size of the civil service. The records of the Public Service Commission (PSC) are not up to date and accurate; specifically, many employees who left the service in the past, are still on PSC's books as active. MISSA administers the compulsory pension and medical contribution of all wage and salary earners, and therefore has the most complete coverage. According to their records, at the end of 1995, there were more than 2,300 people employed in the civil service. A third source of information is the fortnightly civil service payroll, produced by the Ministry of Finance. This list includes casual workers, and the totals therefore fluctuate from pay period to pay period. The report took the 27 October 1995 payroll as the benchmark. On that day, a total of 2,125 civil servants were paid. The total wage and salary bill for those 2,125 civil servants was estimated at $21.7 million. The number was reduced to below 1,800 by the end of 1996.

30. Based on the report, the Rationalization Committee made a decision to reduce the number of civil servants to around 1,484. This represents a decline of more than 30 percent in the number of civil servants. The Committee has analyzed this as follows:

Reduction in the Size of the Civil Service

Number of employees on 31 Dec 1995	2,180
Termination of school-feeding program	-220
Privatization of services in MOTC	-94
Privatization of services in PW	-116
Core Government	1,750
Reduce by 15 percent	-270
New size of Core Government	1,480

MOTC - Ministry of Transport and Communications
PW - Public Works

Source: Government/UNDP report

31. The number of people that will enter the RIF program will be between 490 (if all privatization efforts are 100 percent successful) and 690 (if all privatization efforts fail). It has been assumed that the reality lies in between these two extremes and that 590 people will enter the RIF program.

32. The question of how best to deal with staff who become surplus to requirements during a down-sizing process, through no fault of their own, has been of concern to the Rationalization Committee. Suggestions have been made in previous reports and it was generally concluded that the options presented in these reports, e.g., redeployment and retraining, might not be appropriate in the present circumstances.

33. It has been generally acknowledged that the state of the RMI economy is such that it is highly unlikely that the private sector will be able to immediately absorb many of the public servants who may be declared surplus to requirements as the public service is downsized. It has been concluded therefore that the Government should formulate policies that help to make the transition away from full-time public service employment as smooth as possible. Governments in other countries faced with similar problems have concluded that the most constructive approach is by way of making reasonable severance payments to the employees affected.

34. The Government has decided to follow this approach, although it intends to pursue, at the same time, various policies that will contribute to economic growth, and will include a counseling and training program in the RIF. Based on the Government/UNDP report, with certain modifications, and subject to availability of financing, the Government has opted for a severance payment scheme that consists of two major parts. The first is a lump-sum payment, equivalent to three to nine months of salary, depending on the length of service. The second one is intended as a form of social safety net, and will consist of a monthly maintenance benefit to be paid over a period of three years. Based on average salaries paid in the civil service (ranging from $4,000 to $10,000 per year and average $7,000) and the average length of service, it is estimated that an average of four months of salary will be paid as lump-sum, at a total cost of $1.75 million. The maintenance benefit would be paid out on the basis of the current benefit rules of MISSA, amounting to a payment of $175 to $245 per month, and at a total cost of $1 million per year. Taking into account considerable uncertainties regarding the structure of the group to be included in the RIF program, it has been estimated that the RIF program will cost $3 million in the first year and $1 million in each of the two following years.

35. The payment of the monthly maintenance benefit, which is administered by MISSA, could be through normal channels, i.e., the commercial banks in Majuro. This would, however, have the disadvantage that it would encourage people to remain in Majuro, instead of going to their own island. A mechanism for payment of maintenance benefit on the outer islands needs to be devised.

36. Many civil servants have obtained consumer loans with one or more commercial banks, mortgaging their future salaries. There are no figures available as to the extent of the debts. Anecdotal evidence suggests that debt servicing often amounts to 80 percent or more of the after-tax pay package. The position of the Government is that this is an issue that needs to be addressed on an individual basis between the banks and the persons concerned. The Rationalization Committee will make an effort to asses the extent of the problem and initiate discussions with the three banks concerned.

REPUBLIC OF THE MARSHALL ISLANDS
MINISTRY OF FINANCE
P.O. BOX D
Majuro, Marshall Islands

ASIAN DEVELOPMENT BANK
27 NOV 1996
OFFICE OF THE PRESIDENT

Development Policy Letter

Mr. Mitsuo Sato
President, Asian Development Bank
Manila, Philippines

Dear President Sato,

RMI Public Sector Reform Program Loan

As you may be aware, my Government has commenced a process for implementing the policy reform program outlined in our presentation to the Consultative Group meeting held in Manila, in December 1995. By way of this letter, my Government would like to reconfirm its commitment to those reforms in general, and to the specific reforms which have been agreed upon under the Public Sector Reform Program. 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 from the Asian Development Fund, in support to the Program.

We have been trying to stimulate economic development and attempting to contain the fiscal deficit for a number of years, but with limited sucess. Faced with an increasingly difficult fiscial situation, with the programmed step-down in Compact payments, and the possible reduction in payments after 2001, we requested the ADB to assist in designing and implementing a Policy Reform Program (PRP). This assistance started in July 1995, with the fielding of the Policy Advisory Team (PAT). We adopted the outline PRP in November 1995. Part of the PRP is now being implemented as the Public Sector Reform Program (PSRP), which has three principal objectives: i) to stabilize the Government's finances in the short run, ii) to ensure the long term structural stability of the Government's finances, and iii) to create an improved enabling environment for the private sector. Its scope covers civil service reform, taxation reforms and reforms in the transport sector. The main elements of this Program are briefly outlined below, and a detailed program of action is in the attached Policy Matrix, which forms an integral part of this letter.

A significant number of policy measures were adopted and implemented in the course of 1996. These included the adoption of a new import duty schedule, an increase in the tax on gasoline and the appointment of a revenue administration advisor. Measures to reduce expenditures in the short run included the reduction or elimination of operating subsidies for government-owned corporations, a reduction in wages for the higher wage earners , a normal wage freeze for all civil servants and a 3 percent across-the-board cut in the operating budgets of all ministries. The Government has also reduced the number of ministries from 10 to 6. Last October the Appropriation Act, which was passed to enact the Financial Year 1997 Budget, made provision for the retrenchment of a further 260 government staff. The Public Service Commission (PSC) has already served notice of termination on those staff falling under its' jurisdiction. Notices will very shortly also be prepared for those staff that fall outside of the jurisdiction of the PSC.

Measures for the structural improvement of public finances are to be implemented before the end of FY1997. There are three objectives: (i) reduce recurrent government expenditure by 20 percent, (ii) improve and broaden domestic revenue collection, and (iii) establish funds and/or continue sound management of funds under control of the Government. Measures include: (a) amalgamation of the functions of the Ministry of Social Services with other ministries, (b) freezing of nominal wages for a three year period, (c) merging of the ministries of Resources and Development and Public Works, (d) abolition of the Shipping Corporation, (e) permanently reducing the size of the civil service, (f) establishing the Marshall Islands Visitors Authority (MIVA) as an independent and self-financing entity, (g) reviewing the operational budgets of all ministries, and (h) ending operational subsidies to Air Marshall Islands (AMI).

To improve domestic revenue collection, the tax administration will have to be reorganized. To broaden the revenue base, and at the same time introduce a non-discriminatory tax to stimulate private sector development, a system of VAT and excise duties will be presented to Cabinet for a decision as to its implementation. The introduction needs to be prepared and executed carefully, with the reorganization and strengthening of the tax administration being only the first but necessary step. Domestic revenue collection will be further broadened by increasing the degree of cost recovery in the road transport sub-sector. The Government will also establish a Financial Reserves Trust Fund (FRTF) to allow it to build up a prudent level of financial reserves for the future.

A key element of the program is the reform and down-sizing of the civil service. The civil service reform program was produced as a joint effort between the Government and UNDP, and the final report was presented in December 1995. The program focuses on: (i) the need to reduce costs where possible, and on an on-going basis; (ii) the need to produce a simple, rational and easily understood system; and (iii) the need to produce a structure geared toward achieving the Government's objectives, both economic and social. Within this context, the main concern is to create a civil service which is more affordable than the current one.

The size of the civil service was estimated at 2,200 as of December 1995. The report recommends cutting the number of civil servants down to 1,480 and the number of ministries from ten to six, and to reorganize various administrative functions. The report also contains a number of recommendations to improve personnel management. The Government has started to implement the recommendations of the report. The question of how best to deal with staff who become surplus to requirements during the down-sizing process, has been of concern to the Government. It is acknowledged that the state of the RMI economy is such that it is unlikely that the private sector will be able to immediately absorb many of the public servants who will be retrenched. It has been concluded that the most constructive approach is by way of making reasonable severance payments to the employees affected.

The Government has opted for a severance payment scheme which consists of two major parts. One is a lump-sum payment, equivalent to between zero and nine months of salary, depending on the length of service: the second one is intended as a form of social safety net, and will consist of a monthly maintenance benefit to be paid over a period of three years. The monthly payment (for those employees aged below 55, or those above 55 who are not "service insured", i.e. those that have not made sufficient social security contributions to receive retirement benefits at age 55) would be equal to the benefit the employee would be entitled to receive from social security, calculated as if the employee were age 55 and "service insured". All of the terms and conditions which apply to the payment of social security benefits would apply. This includes the earnings test, which implies that any person subsequently finding a new job within the three year period would have their benefit payment reduced accordingly. In addition, the Government will provide training and counseling services; this is supplemented by a UNDP-funded program for small business training.

The creation of an improved enabling environment for private sector development, the third principal objective of the Program, has many dimensions, including the reduction of the absorption of resources by the Government, the reduction of the influence of the Government on factor prices, making land available as a reliable factor of production, the creation of a transparent regulatory environment and the implementation of clear sector strategies.

The Government's absorption of resources in the economy is foremost a result of its relatively high wage bill, in addition to high levels of other recurrent and capital spending. Part of this problem in being addressed through the PSRP, which will reduce the absolute size of the Government, and thereby recurrent spending, as well as reduce the wage bill through the Reduction-in-Force program (RIF). In addition, it is necessary to allow private sector wages, which are lower on average than public sector wages, to catch up.

Some form of privatization of many of the Government's agencies and corporations is required to free up the economy and improve the impact of market forces to replace bureaucratic decision making. In the absence of a detailed strategy for privatization and in the absence of a capital market, this will take some time to develop. In the short run, three types of actions can be taken. First, the reorganization of the Government's administration, to make it smaller, more transparent, more efficient and concentrated on its core activities only. Second, the appointment of new boards of directors for various government agencies or corporations to ensure private sector majority and to lessen bureaucratic decision making will be implemented. Third, a Private Sector Unit will be established to draw up a privatization strategy and implement it.

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

With warm regards,

Yours sincerely,

Ruben R. Zackhras,
Minister of Finance
Republic of the Marshall Islands

SUMMARY OF THE TRANCHE CONDITIONS

ACTIONS WHICH ARE A CONDITION FOR THE RELEASE OF THE SECOND TRANCHE		
Specific Policy Action	**Target Date for Completion**	**Measurable Indicator**
1. Establish the Private Sector Unit in the Office of the President, consisting of three appropriately qualified part-time members to be appointed by the President, with adequate office and secretarial support	1 February 1997	Cabinet Minutes
2. Reduce the size of the Board of Directors of Air Marshall Islands by reducing its size from nine to five member, including at least two members from the private sector with relevant commercial experience	1 February 1997	Cabinet Minutes
3. Continue the wage freeze for civil servants, which was introduced in March 1996	1 October 1997	Government payroll
4. Reduce the number of Government employees from 1650 to not more than 1484 and compensate each RIFed employee with an up-front payment and monthly maintenance payment over a period of three years	1 October 1997	Government payroll
5. End all subsidies to AMI except for interest payments on the two Dorniers	1 October 1997	Approved 1998 Budget
6. Establish the Financial Reserves Trust Fund	1 October 1997	Deed of establishment

ACTIONS WHICH ARE A CONDITION FOR THE RELEASE OF THE THIRD TRANCHE		
Specific Policy Action	**Target Date for Completion**	**Measurable Indicator**
1. Impose a tax on all rental incomes of commercial buildings	1 October 1997	Approved 1998 Budget
2. Establish the Road Users Trust Fund	1 October 1997	Cabinet Minutes
3. Establish the Marshall Islands Airport Authority	1 October 1997	Act of Parliament
4. Transfer airport management functions from the DCA to MIAA	1 October 1997	Cabinet Minutes
5. Transfer responsibility for the registration of companies to the Registrar of Corporations	1 April 1998	Act of Parliament

MARSHALL ISLANDS PUBLIC SECTOR REFORM PROGRAM 1996-1998

POLICY MATRIX

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
A. Stabilize Government finances in the short run	A1 Increase Revenues	a) Appoint a tax auditor for three months to assess tax revenue arrears	1 Feb 1996*	Report by the Audit Specialist	Audit Report
		b) Introduce a simplified import duty schedule with a basic duty of 12 percent, a duty of 5 percent on some basic needs, and a duty on alcohol and tobacco of 150 percent; the duty on alcohol will be reviewed under the FY1997 budget but will in any case not be lower than 100 percent	1 March 1996*	Inclusion in the approved 1997 Budget and enacted by Parliament	Approved 1997 Budget
		c) Increase revenue collection efforts to collect $0.5 million in arrears	30 Sep 1996*	Lower arrears on 30 September 1996 compared to 31 March 1996	Government cashflow reported by the Ministry of Finance
		d) Double the tax on gasoline	15 January 1997	Cabinet decision	Approved 1996 interim budget
		e) Review all exemptions from paying import duties other than those required by international treaties depending on whether or not a Value Added Tax is introduced	1 Feb 1997	Cabinet Minutes	Marshall Islands Gazette
		f) Review all exemptions from GRT payments depending on whether or not a Value Added Tax is introduced	1 Feb 1997	Cabinet Minutes	Marshall Islands Gazette
		g) Appoint an externally funded tax advisor to the Government on customs, revenue and taxation, for a period of at least two years	31 March 1997	Consultant's contract	Consultant's report

* Completed

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
A. Stabilize Government finances in the short run (continued)	A2 Reduce Expenditures	a) Instruct all ministries to reduce operating expenses by 3 percent	1 March 1996*	Reduce the operations budget of ministries by 3 percent	1996 interim budget
		b) Reduce the operating subsidy to MEC to zero	1 March 1996*	Inclusion in the approved 1996 interim budget and enacted by Parliament	1996 MEC accounts
		c) Eliminate all vacancies in the civil service and introduce a hiring freeze until 1 October 1996, after which the agreed upon staffing ceilings will apply	1 March 1996*	Cabinet decision	Social Security Fund reporting and Ministry of Finance payroll data
		d) Reduce the operating subsidy to MWSC to zero	1 March 1996*	Inclusion in the approved 1996 interim budget and enacted by Parliament	1996 MWSC accounts
		e) Reduce the operating subsidies to Tobolar by 25 percent compared to the original 1996 Budget appropriation	1 March 1996*	Inclusion in the approved 1996 interim budget and enacted by Parliament	1996 Tobolar accounts
		f) Reduce the operating subsidies to AMI by 25 percent compared to the original 1996 Budget appropriation	1 March 1996*	Inclusion in the approved 1996 interim budget and enacted by Parliament	1996 AMI accounts
		g) Retrench around 180 people from the Ministry of Social Services and include them in the RIF program	1 Sep 1996*	A reduction of 180 people on the Sep 1996 payroll	Ministry of Finance payroll data

* Completed

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
B. **Ensure Long Term Structural Stability of Government Finances**	B1 Reduce recurrent expenditure by at least 20 percent at least during the Program period	a) Amalgamate the functions of the Ministry of Social Services with the Ministry of Interior to form the Ministry of Interior and Social Welfare.	1 March 1996*	1996 Interim Budget	Approved 1996 interim budget
		b) Impose a three year wage freeze for civil servants, excluding normal promotions	1 March 1996*	Government payroll on a continuing basis	Approved 1997, 1998 and 1999 Budgets
		c) Merge the Ministries of Resources and Development and of Public Works	1 March 1996*	1996 Interim Budget	Approved 1996 interim budget
		d) Abolish the Marshall Islands Shipping Corporation	1 July 1996*	Act of Parliament	Approved 1997 Budget
		e) Reduce the number of Government employees to around 1650 persons and compensate each RIFed employee with an up-front payment and a monthly maintenance payment over a period of three years, as per formula agreed upon between the Government and the Bank and implemented by the Marshall Islands Social Security Administration (MISSA)	1 Octo 1996	Government Payroll on 1 Oct 1996	Approved 1997 Budget
		Second Tranche Condition **h) Reduce the number of Government employees from 1650 to 1484 persons, and compensate each RIFed employee with an up-front payment and a monthly maintenance payment over a period of three years, as per formula agreed upon between the Government and the Bank and implemented by MISSA.**	**1 Oct 1997**	**Government Payroll on 1 Oct 1997**	**Approved 1998 Budget**
		i) Review and reduce as appropriate each Ministry's operational budget based on its revised Terms of Reference, to be developed under C1 sub g) in this matrix	1 Oct 1997	Operational costs of Government,	Approved 1997 Budget

* Completed

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
B. Ensure Long Term Structural Stability of Government Finances (Continued)	B1 Reduce recurrent expenditure by 20 percent at least during the Program period (Continued)				
		Second Tranche Condition j) End all subsidies to AMI, except for the interest payments on the two Dorniers	1 Oct 1997	Approved 1998 budget	1997/98 AMI accounts
		Second Tranche Condition k) Continue the three-year wage freeze for civil servants introduced in March 1996, excluding normal promotions	1 March 1999	Government payroll on a continuing basis	Approved 1997, 1998 and 1999 Budgets

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
B. **Ensure Long-term Structural Stability of Government Finances (continued)**	B2 Improve and Broaden Domestic Revenue Collection	a) Undertake a study on the reform of the taxation system, including the consideration of a Value Added Tax, changes in the income tax, import duties and Gross Revenue Tax (GRT), bearing in mind resource needs, administrative efficiency and economic resource implications	1 Sep 1996*	Study report	Ministry of Finance reporting
		b) Undertake a Revenue Administration Study on reorganizing the Revenue Division with the aim of improving collection efficiency, improving productivity and preparing the Division for future changes and improvements in the tax system	1 Sep 1996*	Study report	Ministry of Finance reporting
		c) Cabinet presentation of the report on tax reform, and adoption of measures deemed appropriate by Cabinet	15 Jan 1997	Cabinet Minutes	Ministry of Finance directives
		d) Reorganize the Revenue Division as recommended by the Revenue Administration Study and as agreed between the Government and the Bank	1 March 1997	New organigram published by the Ministry of Finance	Ministry of Finance 1998 Budget submission, PSC records
		e) Improve customs operations as recommended by the Revenue Administration Study and as agreed between the Government and the Bank	1 March 1997	Substantial increase in import duties collected	Instructions issued by the Chief of Customs and revenue reporting
		f) Computerize the Revenue, Customs and Taxation Division	1 July 1997	Monthly print-outs showing revenues realized and revenues due	Ministry of Finance reporting
		Third Tranche Condition **g) Impose a tax on all rental incomes of commercial buildings**	**1 Oct 1997**	**1998 budget**	**Approved 1998 Budget**
		h) Increase the degree of cost recovery and revise road user charges, including vehicle registration fees and fuel taxes,in accordance with the recommendations of TA 2068-RMI: Transport Infrastructure Development	1 Oct 1997	Cabinet Decision	Approved 1998 budget
		i) Revise the existing vehicle classification and, based on this, annual registration fees in accordance with the recommendations of TA 2068-RMI: Transport Infrastructure Development	1 Oct 1997	Cabinet Decision	Approved 1998 budget

* Completed

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
B. **Ensure Long Term Structural Stability of Government Finances (continued)**	B3 Establish and/or continue sound management of funds under the control of the Government, including RIF funds	a) Appoint a new Board of Directors of the Social Security Fund, to increase private sector representation	15 Jan 1996*	Cabinet Decision	Cabinet Minutes
		b) Retain the services of a professional actuary and a professional pension fund manager on a full-time basis to ensure the continued integrity of the funds administrated by MISSA	Continuous, beginning January 1996	Continued investments according to sound and accepted investment principles	Actuary's Reports
		c) By a method to be agreed upon by the Government and the Bank, appoint representatives from beneficiaries and potential beneficiaries of the funds administrated by MISSA, on the Board of MISSA	1 Feb 1997	Cabinet decision	Cabinet Minutes
		Second Tranche Condition **d) Establish a Financial Reserves Trust Fund that will enable the creation of financial reserves at the disposal of the Government for periods of severe financial difficulties, with details to be agreed upon between the Government and the Bank**	**1 Oct 1997**	**Deed of Establishment**	**Cabinet Minutes**
		Third Tranche Condition **e) Establish the Road Users Trust Fund to ensure adequate funding for routine and periodic road maintenance and road traffic safety and assign an adequate portion of the proceeds of road user charges to such fund and the balance to the general budget**	**1 Oct 1997**	**Cabinet decision**	**Cabinet Minutes**
		f) Perform an annual audit of the Road Users Trust Fund by an independent auditor and implement the auditor's recommendations to ensure long-term viability of the Fund	Annually, beginning Oct 1998	Size of the Fund	Auditors Reports

* Completed

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
C. **To create an improved enabling environment for the private sector**	C1 Reduce Government's involvement in the economy	a) Appoint a professional and experienced interim manager for AMI, and provide management with the necessary support to reorganize and streamline the organization with the aim of making AMI financially sound. Retrench at least 50 of the 120 staff	1 Feb 1996*	Manager's Contract	Board minutes
		b) Pursue a least-cost option of ending the lease contract for the DC-8 and implement it	1 Sep 1996*	Cabinet Decision	AMI accounts
		c) Appoint a permanent CEO who is an internationally qualified professional and experienced airline manager, with a remuneration package in accordance with international standards, and fully implement the other recommendations made in Appendix 1 of the 'Air Marshall Islands Review' Report	1 Feb 1997	Board Decision	CEO's contract
		d) Provide AMI management with clear delegated powers and adequate resources, including an operating budget, to manage the airline, including tariffs, flight schedules and personnel matters on a strictly professional basis	1 Feb 1997	Board Decision	Board Minutes
		Second Tranche Condition **e) Reduce the Board of Directors of AMI from nine to five members, ensuring that at least two members are from the private sector with relevant commercial experience**	**1 Feb 1997**	**Cabinet Decision**	**Cabinet Minutes**
		Second Tranche Condition **f) Establish a Private Sector Unit in the Office of the President for a period of no longer than two years. The Unit will consist of three appropriately qualified part-time members to be appointed by the President, with adequate office and secretarial support.**	**1 Feb 1997**	**Cabinet Decision**	**Cabinet Minutes**

* Completed

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
C. To create an improved enabling environment for the private sector (continued)	C1 Reduce Government's involvement in the economy (continued)	g) Prepare a detailed action plan for the implementation of the the Government/UNDP Public Sector Management Improvement Program (PSMIP) Report, as outlined in the December 1995 report of the Rationalization Committee and which includes new terms of references for all ministries, staffing requirements and improved personnel management methods	1 Feb 1997	Detailed and implementable action plan including allocation of responsibilities, resource needs, and time table	Consultant's reports, Rationalization Committee minutes
		h) The Private Sector Unit will complete its review of government public sector enterprises, including AMI, domestic shipping, Majuro Water Supply and Sewerage Company, Marshalls Energy Company, Nantional Telecoms Authority and others, develop a preliminary framework for private sector regulation, its conclusions and recommendations will be submitted to Cabinet for review and implementation in a manner to be agreed upon between the Government and the Bank	1 July 1997	Private Sector Unit's Report	Cabinet Minutes
		i) The Private Sector Unit will complete its review of Tobolar, taking into account the Government's social policy associated with copra production and recognizing the importance of copra for cash incomes on the outer islands	1 July 1997	Private Sector Unit's Report	Cabinet Minutes
		j) Conduct a comparative study of private and public sector salaries to provide an improved basis for setting public sector salaries, and establish a methodology for regular monitoring	1 July 1997	OPS Report	OPS Report
		Third Tranche Condition **k) Establish the Marshall Islands Airport Authority (MIAA) by legislative enactment, in order to provide a more efficient and cost effective airport management service, which is self-financing**	**1 Oct 1997**	**Act of Parliament**	**Marshall Islands Gazette**
		Third Tranche Condition **l) Transfer all airport management functions currently undertaken by CAD to the new MIAA**	**1 Oct 1997**	**Cabinet Decision**	**Cabinet Minutes, MIAA Board Minutes**
		m) Implement the action plan for the PSMIP, including the reorganization of the ministries, new job descriptions for civil servants, a new job grading system and the provision of adequate incentives	1 Jan 1998	Government organigram published in the Marshall Islands Gazette	Consultant's reports, Rationalization Committee minute minutes

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
C. To create an improved enabling environment for the private sector (continued)	C1 Reduce Government's involvement in the economy (continued)				
		n) Re-establish the Marshall Islands Visitors Authority (MIVA) with a Board of Directors, with majority private sector representation and produce a business plan aimed at reducing Government support to zero within a period of three years; MIVA will become the focal point for tourism development in the Marsall Islands	1 Feb 1997	Cabinet Decision to establish tMIVA; published business plan	Business plan and annual accounts
		o) Undertake a study to review the privatization procedures which were followed regarding domestic shipping operations and implement the study's recommendations as agreed between the Government and the Bank	1 Feb 1997	Consultant's contract, Cabinet minutes on shipping	Marshall Islands Gazette; Approved 1998 Budget

Primary Objectives	Secondary Objectives	Specific Policy Actions	Target Date for Completion	Measurable Indicators	Monitoring Mechanism
C. **To create an improved enabling environment for the private sector (continued)**	C2 Improve the regulatory environment	**Third Tranche Condition** **a) Registration of companies to be the sole responsibility of the Registrar of Corporations, in order to ensure fair and transparent treatment of all companies**	**1 April 1998**	**Act of Parliament**	**Marshall Islands Gazette**
		b) Review of the policy and procedures for employment of non-citizens to ensure that the requirements and procedures to issue work permits becomes more transparent, in a manner to be agreed upon between the Government and the Bank	1 April 1998	Cabinet Paper	Cabinet Minutes
		c) The procedures for issuing of business and foreign investment licenses will be made more transparent and automatic, in a manner to be agreed upon between the Government and the Bank	1 April 1998	Cabinet Paper	Cabinet Minutes
		d) Government to guarantee foreign investment protection by applying for membership in MIGA and ICSID; enact national legislation to allow for comprehensive foreign investment protection	1 April 1998	Cabinet Minutes, Act of Parliament	Marshall Islands Gazette
		e) Enact legislation for the establishment of the Office of the Ombudsman, to ensure independent arbitration between the Government and the public at large, with procedures and powers to be agreed upon between the Government and the Bank	1 May 1998	Cabinet Minutes, Act of Parliament	Marshall Islands Gazette
		f) Enact legislation and procedures to guarantee legal security of land leases as well as peaceful enjoyment of the right of occupancy under the lease, while ensuring that all concerned customary owners receive a return on land leased commensurate with market conditions	1 May 1998	Cabinet Minutes, Acts of Parliament	Marshall islands Gazette

PROPOSED TECHNICAL ASSISTANCE FOR PROGRAM IMPLEMENTATION

1. The Government has requested the inclusion of technical assistance (TA) in the proposed Bank assistance, to enable the Government to implement its Public Sector Reform Program (PSRP). The provision of such TA is critical to the PSRP, in the light of the limited implementation capacity of the Government. In view of the urgent need to implement the reforms, there is little time and opportunity for capacity building to provide the Government with the necessary skills to implement the reforms. Rather, the reforms need to be implemented to create an administration that will have the capacity to manage the country more efficiently, and will be capable of implementing the next round of reforms.

2. Three TA projects are proposed: (i) Program Coordinator, (ii) Institutional Strengthening of the Transport Sector, and (iii) Establishment of a Private Sector Unit.

A. Program Coordinator

1. Background

3. The Government of the Republic of the Marshall Islands (RMI) has embarked on a long-term policy reform program, to cope with the projected decline or possible ending of grant funds received under the Compact of Free Association with the United States in 2001. Reforms need to be implemented to bring Government expenditure in line with projected revenues, and, more importantly, to prepare the economy for the post-Compact period. With Bank assistance,[1] the Government has designed a Policy Reform Program, which was endorsed by the international donor community at the Consultative Group meeting in December 1995.

4. Based on this program, the Government and the Bank have worked together to design the Public Sector Reform Program (PSRP), which focuses on three main objectives: (i) to stabilize the Government's finances in the short term; (ii) to make the Government's finances structurally sound in the medium term; and (iii) to create an enabling environment for the private sector. The PSRP requires the Government to take many, different and coordinated actions, including studies, Cabinet papers, submissions to Parliament, recruitment of consultants and the running of various working committees, according to a time table agreed upon between the Government and the Bank. The services of a Program Coordinator are required to ensure that timely action is taken by those concerned in order to keep the implementation of the PSRP on track.

2. Objectives and Scope

5. The objectives of the TA are:

(i) assisting the Rationalization Committee in implementing the PSRP;

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[1] TA No. 2294-FSM: *Policy Advisory Team for Economic Management*, for $2.5 million approved on 31 January 1995.

(ii) ensuring that timely and appropriate actions are being taken, for the PSRP to be implemented according to the agreed time schedule; and

(iii) advising the Government on all aspects of Program implementation.

6. The scope of the TA includes:

(i) establishment of a technical support unit (secretariat) for the Rationalization Committee;

(ii) for each element of the Program, the TA will design a detailed action plan for implementation, including identification of responsible offices, coordination between the different offices involved, drafting of the necessary Cabinet papers, memos and other papers as required for action, design of a detailed timetable and follow-up of actual implementation;

(iii) coordination between different ministries and agencies involved in the PSRP, and the Rationalization Committee;

(iv) ensuring the timely implementation of all the elements of the PSRP; and

(v) reporting on progress of implementation on a regular basis to the Government and the Bank.

3. Consulting Services

7. The services of an international consultant will be required for a period of 24 months. The consultant will have a background in development economics, finance, accounting or law. The consultant will have a proven track record in successfully managing projects in the Pacific or similar environments. The consultant, who will be an individual, will be engaged in accordance with the Bank's *Guidelines on the Use of Consultants*.

4. Cost Estimates and Financing Plan

8. The total cost of the TA is estimated at $560,000, including $460,000 in foreign exchange costs and $100,000 in local currency costs. The Bank will provide $515,000 to finance the entire foreign exchange cost and part of the local currency cost. The TA will be financed by the Bank on a grant basis. The Government's contribution will be $45,000. Table 1 gives the cost estimate and financing plan.

Table 1: Cost Estimates and Financing Plan
($)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing			
1. Consultant (Remuneration, Per Diem, Housing)	380,000		380,000
2. Local Transport		25,000	25,000
3. International Travel	20,000		20,000
4. Seminars, Training, Communications		20,000	20,000
5. Contingencies	60,000	10,000	70,000
Total (A)	460,000	55,000	515,000
B. Government Financing			
1. Office Accommodation		20,000	20,000
2. Support Services		25,000	25,000
Total (B)		45,000	45,000
Total	**460,000**	**100,000**	**560,000**

5. Implementation Arrangements

9. The Executing Agency will be the Rationalization Committee. The individual consultant will work closely with and under the responsibility of the Rationalization Committee.

6. Terms of Reference

10. The tasks of the consultant will include:

(i) assisting the Rationalization Committee in setting up a technical support unit, or secretariat, that will be responsible for the day-to-day coordination of the implementation of the PSRP;

(ii) designing a detailed action plan for the implementation of each element of the PSRP, including the identification of responsible offices, coordination between the different offices involved, drafting of the necessary Cabinet papers, memos and other papers as required for action, design of a detailed timetable and follow-up of actual implementation;

(iii) coordination between different ministries and agencies involved in the PSRP;

(iv) reporting, on a timely basis, to the Rationalization Committee and the Bank on progress made with the implementation of the PSRP, and early identification of problems encountered; and

(v) other tasks as required to ensure appropriate and timely action is taken for the continued implementation of the PSRP.

B. Institutional Strengthening of the Transport Sector

1. Background

11. Several Government agencies and special purpose authorities share responsibility for the transport sector. The Ministry of Transportation and Communications (MOTC) is only formally at the apex of transport administration. MOTC does not have any responsibilities in regard to roads and road traffic. Its planning role is limited to ports and shipping and it does not carry out policy formulation. Essentially, MOTC is responsible for the regulation of domestic and overseas shipping, operates the Government shipping fleet, and manages the docks at Delap and Uliga on Majuro, and Jabwor on Jaluit Atoll. MOTC day-to-day operations are supervised by the Secretary, who is responsible to the Minister. The Secretary holds administrative responsibilities under various maritime legislation for the regulation of shipping, with the exception of the Marshall Islands Register of Shipping which is the responsibility of a Maritime Administrator.

12. Transport infrastructure is provided and maintained by several Government agencies. The Ministry of Public Works (MPW) maintains the roads on Majuro as part of its wider infrastructure maintenance responsibilities and shares outer island airport development and maintenance with the Ministry of Resources and Development Ministry (MRD). MRD undertakes construction and heavy maintenance work on aerodromes and roads on the outer atolls. The Department of Public Safety provides road traffic enforcement and administration and has harbor patrol responsibilities. The Kwajalein Atoll Development Authority (KADA) promotes the development of the Kwajalein Atoll including transport infrastructure projects. The Ebeye Port Commission is a special purpose authority under KADA and administers the port of Ebeye. Air Marshall Islands (AMI), the Government-owned national airline, plays a vital role in condition inspection of outer atoll aerodromes. The Civil Aviation Directorate (CAD) has statutory responsibilities for aviation regulation and has been entrusted by MOTC with the management of Majuro Airport. The Director of CAD is directly responsible to the Minister of MOTC, although the Secretary, MOTC, is accountable for the management and upkeep of Majuro Airport and the outer island aerodromes.

13. The transport sector offers significant opportunities to make a contribution to improving the Government's difficult financial situation. Financial losses incurred by Government transport operations currently total about $7.3 million and account for about 9 per cent of gross domestic product (GDP). With its focus on key reforms in the transport sector, the proposed TA is designed to facilitate the process of transition of the economy to a more self-reliant and sustainable level. The proposed transport sector reforms will play a strategic role in this process and will provide a contribution to GDP growth. The proposed TA will provide the various types of expertise required to successfully implement the reforms.

2. Objectives and Scope

14. The objectives of the TA are:

(i) reducing transport costs and improving service quality by commercializing transport operations with respect to port and airport operations; and

(ii) improving cost recovery levels and maintenance funding for roads.

15. The scope of the TA includes:

(i) prerequisite steps to create and operate two Government corporations, the Marshall Islands Ports Authority (MIPA) and the Marshall Islands Airports Authority (MIAA), as autonomous entities, notably the preparation of corporate plans, including mission statements, marketing and pricing strategies, and investment plans;

(ii) revision of road user charges to improve the level of cost recovery and the creation of a Roads Trust Fund to improve funding for road maintenance.

3. Consulting Services

16. To carry out the required tasks, a total of 15 person-months of international consultants with expertise in the following fields will be needed: (i) road transport economics (2 person-months); (ii) corporate planning and management for ports and airports (4 person-months); (iii) management development (6 person-months); (iv) public funds administration (1 person-month); and (v) commercial law (2 person-months). It is conceivable that one consultant may possess one or more of the qualifications. The consultants, who will be recruited through a firm, will be engaged in accordance with the Bank's *Guidelines on the Use of Consultants*.

4. Cost Estimates and Financing Plan

17. The total cost of the TA is estimated at $620,000, including $520,000 in foreign exchange costs and $100,000 in local currency costs. The Bank will provide $575,000 to finance the entire foreign exchange cost and part of the local currency cost. The TA will be financed by the Bank on a grant basis. The Government's contribution will be $45,000. Table 2 gives the cost estimate and financing plan.

Table 2: Cost Estimates and Financing Plan
($)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing			
1. Consultant (Remuneration, Per Diem)	380,000		380,000
2. Local Transport		20,000	20,000
3. International Travel	50,000		50,000
4. Equipment	20,000		20,000
5. Local logistical support		30,000	30,000
6. Contingencies	70,000	5,000	75,000
Total (A)	520,000	55,000	575,000
B. Government Financing			
1. Office Accommodation		20,000	20,000
2. Support Services		25,000	25,000
Total (B)		45,000	45,000
Total	**520,000**	**100,000**	**620,000**

5. Implementation Arrangements

18. MOTC will be the Executing Agency and will co-ordinate the activities under the TA with the Government agencies concerned with the proposed reforms. All activities under the TA with direct or indirect relevance to policy formulation will have to be closely coordinated with the Policy Advisory Team for Macro Economic Management (PAT) financed under a separate TA from the Bank. Toward this end, a consultation mechanism will have to be worked out and agreed upon between the two teams.

19. The TA will be carried out over 18 months and will involve intermittent visits by the consultants. It is envisaged that the TA will commence in February 1997 and will be completed in August 1998.

20. At the end of the first month of their assignment, the consultants will prepare an inception report, discussing initial observations, highlighting problems to be addressed immediately, and proposing a work plan and a timetable for the implementation of the individual tasks under the TA. To enable a mid-term review to be carried out by the Government and the Bank, the consultants will submit an interim report after the eighth month of their assignment. A draft final report will be forwarded to the Government and the Bank after the 16th month. It will report the accomplishments as against the objectives of the TA, highlight the constraints encountered, and propose remedial action, if required. Five copies each of the required reports will be submitted to the Bank, MOTC, PSC, Office of International Development Assistance (OIDA) and Office of Planning and Statistics (OPS).

6. Terms of Reference

a. Marshall Islands Ports Authority

21. The assistance required relates to a review of the Constitution and Bylaws of MIPA, the drafting of a corporate plan, the design and implementation of commercial, financial, operational, administrative, and maintenance systems, and the preparation of training programs for MIPA staff.

i. Constitution and Regulations and Transfer of Assets

22. The Constitution of MIPA is set out in the Marshall Islands Port Authority Act 1994. The Act allows the Board of Directors to make regulations; it needs to be reviewed to ensure that it reflects the objectives of the Government. Modifications that may be necessary need to be drafted. The Port's area of authority will also have to be defined under this task. Consultant's input: 1.5 person-months of a lawyer with a background in commercial law.

ii. Draft Corporate Plan

23. The corporate plan will specify MIPA's targets, strategies, and operating requirements. It will include financial and operational objectives, marketing targets, and appropriate staffing levels. Consultant's input: 2 person-months of a port management specialist.

iii. Management Systems Development

24. This task includes the evaluation of assets and liabilities to be transferred to MIPA, the introduction of and training in management systems, including financial accounting and reporting, and management information. The choice of an appropriate system, its design and implementation, and the training of staff are included in this task.

25. Consultant's input: A total of 4 person-months will be needed to perform this task. The management systems will cover the whole systems requirement for the Port Authority. The choice of an appropriate system, its design and implementation and the training of staff are all included in the TA. The consultants will need skills in design and operation of finance systems, port management systems, and engineering management systems. Staff will need to be trained in how to operate the systems that are to be implemented. To expand their knowledge of port operations a program for ongoing training of staff, especially senior and middle management, needs to be designed.

b. Marshall Islands Airports Authority

26. The airports management functions currently undertaken by Civil Aviation Directorate (CAD) under delegated authority from MOTC would be transferred to a new MIAA. The assistance required relates to the creation of an autonomous airport authority and the transfer of assets and liabilities, financial implications associated with the proposed authority, including drafting of a corporate plan, the design and implementation of commercial, financial, operational, administrative and maintenance systems, and the preparation of training programs for MIAA staff.

i. Constitution and Regulations

27. There is no empowering legislation for a MIAA. A resolution by the Nitijela (House of Representatives) to establish MIAA and an empowering act similar in nature to that of MIPA, or possibly more simply under Marshall Islands company law, will be needed. Consultant's input: 1 person-month of a lawyer with a background in commercial law.

ii. Draft Corporate Plan

28. The corporate plan will specify MIAA's targets, strategies and operating requirements. It will include financial and operational objectives, and marketing targets. The Government-owned airports infrastructure and equipment at Majuro Airport would be vested in MIAA, again at its asset valuation. This would exclude buildings and equipment owned by Air Marshall Islands. Consultant's input: 2 person-months of an airport management specialist.

iii. Management Systems Development

29. This task includes the evaluation of assets to be transferred to MIAA, the introduction of and training in management systems, including financial accounting and reporting, and management information. The choice of an appropriate system, its design and implementation and the training of staff are included in this task.

30. Consultant's input: A total of 2 person-months will be needed to perform this task. The management systems will cover the whole systems requirement for MIAA. The choice of an appropriate system, its design and implementation, and the training of staff are all included in the TA. The consultants will need skills in design and operation of finance systems, port management systems, and engineering management systems. Staff will need to be trained in how to operate the systems that are to be implemented. To expand their knowledge of port operations, a program for ongoing training for staff, especially senior and middle management, needs to be designed.

c. Road User Charges and Maintenance Trust Fund

31. A Roads Trust Fund has been repeatedly recommended by the US-funded Operation and Maintenance Improvement Program (OMIP) but has not been set up. Present road user charges are part of the general budget and are not earmarked for road maintenance. The tariff of road user charges is too low and does not cover the cost of road administration, not to mention road maintenance.

i. Roads Trust Fund

32. The task comprises all steps necessary to set up a roads trust fund for the purpose of collecting from road vehicle users revenue to be applied to road maintenance and traffic enforcement. Consultant's input: 1 person-month of a specialist in the field of public fund administration will be required to carry out this task.

ii. Road User Charges and Vehicle Classification

33. The task will involve a review of current road user charges, the setting of cost-based tariffs, and a revision of annual vehicle registration fees and vehicle classes. Consultant's input: 2 person-months of a road transport economist will be required to carry out this task.

C. Establishment of a Private Sector Unit

1. Background

34. As part of its PSRP, the Government is committed to reducing its involvement in the economy. At present, the Government owns a number of corporations and agencies which are involved directly in the economy. Political decision-making in those corporations leads to suboptimal decisions on issues, such as resource allocation and pricing. Outright privatization, as has been practiced elsewhere, might not be the most desirable solution, in the absence of a capital market. To deal with the problem of an appropriate form of privatization and to deal with regulatory problems, a Private Sector Unit will be established in the Office of the President. The Unit will be established for two years only, and be composed of three senior civil servants who will be assigned to the Unit on a part-time basis.

35. The purpose of the Unit would be to assist the Government to (i) privatize, in whatever form or shape, its agencies and corporations; and (ii) develop the preliminary framework needed for private sector regulation. First, the Unit will establish guiding principles and methods for privatization, and then assess each potential candidate as to the most suitable method of privatization. Second, with guidance and input from external consultants, the Unit will (i) assist and coordinate in drafting the required legislation for the establishment of reconstituted or new entities such as MIAA, MIPA, MIVA, Office of the Ombudsman, and to guarantee protection of foreign investment and legal security of land leases; and (ii) establish guiding regulatory and operational methodologies for the reconstituted or newly established entities such as MIAA, MIPA and MIVA, covering subjects such as self-financing, setting of appropriate tariffs, accountabilities and enforcement procedures.

2. Objectives and Scope

36. The objectives of the TA are:

(i) establishing a Private Sector Unit in the Office of the President, that will initiate and coordinate all activities in connection with commercializing, corporatizing or privatizing public entities;

(ii) establishing guiding principles and methods for privatization;

(iii) identifying a priority list of entities to be privatized and initiating appropriate actions;

(iv) assisting in drafting required legislation for establishment of reconstituted or new entities such as MIAA, MIPA, MIVA, Office of the

Ombudsman, and to guarantee protection of foreign investment and legal security of land leases; and

(v) establishing guiding regulatory and operational methodologies for reconstituted or newly established entities such as MIAA, MIPA and MIVA covering subjects such as self-financing, setting of applicable tariffs, appropriate accountabilities and enforcement procedures.

3. Consulting Services

37. The services of 20 person-months of international consultants will be required. Eight person-months will be for a privatization specialist, who will assist in the establishment of the Unit. The balance of 12 person-months will be for specialist input in the fields such as capital markets, manufacturing, telecommunications, energy, air transport, sea transport, banking, and water supply. The exact fields of expertise and duration of assignment for each will be determined by the Unit and the first consultant. Consultants will be recruited through a firm, in accordance with the Bank's *Guidelines on the Use of Consultants*.

4. Cost Estimates and Financing Plan

38. The total cost of the TA is estimated at $830,000, including $690,000 in foreign exchange costs and $140,000 in local currency costs. The Bank will provide $760,000 to finance the entire foreign exchange cost and part of the local currency cost. The TA will be financed by the Bank on a grant basis. The Government's contribution will be $70,000. Table 3 gives the cost estimate and financing plan.

Table 3: Cost Estimates and Financing Plan
($)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing			
1. Consultant (Remuneration, Per Diem)	520,000		520,000
2. Local Transport		30,000	30,000
3. International Travel	50,000		50,000
4. Equipment	30,000		30,000
5. Local logistical support		30,000	30,000
6. Contingencies	90,000	10,000	100,000
Total (A)	690,000	70,000	760,000
B. Government Financing			
1. Office Accommodation		30,000	30,000
2. Support Services		40,000	40,000
Total (B)		70,000	70,000
Total	**690,000**	**140,000**	**830,000**

5. Implementation Arrangements

39. The President's Office will be the Executing Agency for this TA. The consultants will report to the President's Office. The team leader will submit an inception report one month after the start of the project. Two progress reports will be submitted during the assignment, and one final report will be submitted towards the end of the TA. In addition, the reports produced by each of the short-term specialists will be made available within one month of completing the relevant assignment.

6. Terms of Reference

a. Team Leader

40. The Team Leader will be assigned for a period of 8 months, during which the following tasks will be undertaken:

(i) assisting with the establishment of the Private Sector Unit, including drawing up its terms of reference, establishing its membership and establishing operating procedures;

(ii) reviewing the progress achieved by the Government in the commercialization and/or privatization of public enterprises since 1990, and identification of the main problems and constraints encountered in implementing the program;

(iii) reviewing the Government's involvement in the ownership and management of various corporations and agencies and identification of the needed reorganization of business activities currently undertaken by those enterprises that would offer the best prospects for their profitable, autonomous undertaking;

(iv) identifying, if any, public sector enterprises that might be terminated because of the absence of the prospects mentioned under (iii) ;

(v) based on this review, draw-up an workplan for the Private Sector Unit, including identification of the required short-term expertise, and the writing of their terms of reference; and

(vi) developing a preliminary framework for private sector regulation. This framework should establish the principles of private sector regulation in RMI, identify the institutional arrangement necessary for effective implementation, and analyze the constraints towards achieving the objectives of private sector regulation.

b. The Team

41. The exact composition of this team depends on the activities of the Team Leader. It is likely however, that most team members will be involved only for periods up to three weeks at a time, in some cases much less. The team will be involved in:

(i) preparing policy papers and draft legislation, where necessary, for consideration by the Government to allow the establishment and operation of various business units that would be necessary for implementing the reorganization of the various public sector enterprises as identified;

(ii) preparing three-year business plans for the operation of each business unit, including detailed business development and marketing plans, financing plans, and management and staffing plans;

(iii) assisting with the identification of appropriate Boards of Directors and management teams for each unit;

(iv) preparing an action plan for the implementation of the output form the above tasks and for the privatization or other divestment of those business units that the consultants consider can be practicably privatized or divested; and

(v) assisting, where possible, the Unit with the implementation of the action plan.

POVERTY IMPACT ASSESSMENT

A. Introduction

1. The reforms proposed under the Public Sector Reform Program (PSRP) will have significant social and economic implications for the Marshall Islands. The PSRP envisages retrenchment of public service employees, privatization of a number of Government services, and a freeze in wages for public service employees who retain their employment. Together, these actions will result in loss of welfare for individuals, and the households and families these individuals support. At the same time, the PSRP proposes a significant reduction in Government spending, increased tax collection, and other fiscal reforms. Because of the reduced level of wage money available in the economy and reduced levels of Government spending, it can be expected that there will be a significantly lower level of activity in the economy, particularly in the monetized economies of Majuro and Ebeye. This will also have implications for the private sector.

2. Fiscal consolidation will frustrate human resource development and the provision of social and other Government services at current and previous levels. Expenditures for education and training and for health services will be curtailed, such that it becomes imperative to find ways to utilize available resources in the most effective manner. The positive result to be achieved from the reform and restructuring envisaged under the PSRP is avoidance of the fiscal collapse of the Government and resultant social and economic instability. In the longer term, the more effective and more rational performance of the Government will create an economic environment that will be more conducive to and supportive of sound economic development led by the private sector.

3. While some negative effects possibly may be postponed or mitigated, they cannot be avoided. Adjustments envisaged under the PSRP must be undertaken immediately, with a view to expeditiously establishing a rationalized public sector and encouraging the private sector. The social and economic consequences of not undertaking reform and restructuring will in the long run be much more severe.

4. The PSRP includes social safety net provisions to mitigate the negative effects. Compensation, both immediate and over a period of time, will be paid to employees who lose employment. As part of the Retirement-in-Force (RIF) program, the Government will provide training and counseling retrenched employees to assist them in adjusting to their new circumstances and in identifying alternative economic opportunities. A UNDP-supported project will assist with training of prospective entrepreneurs.

B. Measuring Impact of Reform and Restructuring Under the PSRP

1. Impact of the PSRP

5. The PSRP does not contain any individual component or has an overall design feature that will impact more directly or more significantly on the poor or other vulnerable groups compared with other nonpoor, nonvulnerable groups. Other than for those persons directly affected by loss of employment through public service retrenchment, effects of the PSRP will be shared across the economy.

6. While the poor are not affected directly by, it can be expected that the poor and other vulnerable groups will be the elements of society first to be affected by the PSRP's overall effects. The poor will be the group least able to cope with negative effects as they are not in a position to protect their interests or seek alternatives, compared with better-off elements of society. In the context of the PSRP, the poor can be regarded as the crucial vulnerable group; ethnic minorities, indigenous peoples, castes, and other vulnerable groups are not a factor in the Marshall Islands.

2. Methodology

7. The Bank's methodology for social impact assessment of program loans notes that analyzing the specific impact of programs on economic conditions -- primary impact, secondary impact and macro-level impact -- is difficult. Analyzing the social impact is virtually impossible without first determining the economic impact. The methodology the Bank has developed for analyzing the overall social impact of program loans focuses therefore on the analysis of the economic impact on the poor and other vulnerable groups. A quantitative assessment of poverty impact is difficult to make, if not impossible. From the methodological perspective, there are no specific indicators or measures that quantify the impact that reforms and restructuring under the PSRP will have in general or on a specific group.

8. The Bank's methodology for poverty impact assessment regards the poor as the crucial and largest vulnerable group. Other groups are vulnerable because they suffer some specific disadvantage in addition to being poor; most often, this additional disadvantage is compounded by poverty. The Bank's methodology employs a qualitative, prospective, with-and-without approach, analyzing the expected poverty-related effects of the PSRP in three possible scenarios. In applying this methodology, three scenarios have been developed.

9. Scenario 1 assumes that virtually none of the reforms proposed under the PSRP will be implemented within the next year. It is assumed in this scenario that the Government will encounter severe fiscal difficulties, leading to default on payment obligations. This, in turn, would cause a crisis in the private sector based on late or nonpayment of Government accounts. The Government would be forced to immediately reduce public service wage levels, immediately reduce the size of the public service, or both. These actions would be taken on a crisis basis, involving strong social and political reactions.

10. Scenario 2 assumes that the Government will implement the reforms planned under the PSRP, but without external financial support. Public service employees to be retrenched would receive no compensation and external funds would not be available for other social safety net provisions. Without external financial support, only part of the macroeconomic and fiscal stabilization objectives would be met. It is assumed that with incomplete reform, the longer term outlook for economic recovery and stabilization would improve only marginally. Scenario 3 assumes that the PSRP reforms are implemented as planned, including external financial and technical assistance support.

11. The expected impact of the PSRP is analyzed in terms of four main channels through which the PSRP can affect the poor: (i) the demand for unskilled labor; (ii) the prices of 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 effects of the PSRP on the poor through these four channels have been grouped into four categories: (i) direct effects, (ii) indirect effects, (iii) macroeconomic effects, and (iv) effects on non-poor who become poor as a consequence of PSRP effects. As the monetized economy of the Marshall Islands is

overwhelmingly service-oriented, with relatively little domestic production of goods, analysis of prices focuses on the price of goods bought by the poor. Goods produced by the poor represent a very small part of gross domestic product (GDP), with most of this production on a subsistence or barter basis, with the good not entering the formal market.

12. In addition to this narrative, a set of four-by-four matrices analyzing the impact of specific PSRP components on the poor has been added. The objective is to analyze whether the PSRP will increase or decrease the income and welfare of the poor, and whether the change will be large or small. A complicating factor in undertaking poverty analysis is that no previous work in the area of poverty analysis for the Republic of the Marshall Islands has been done. No definitions have been established for the country to identify who the poor actually are; no poverty line or other definition of poverty has been established.

C. Policy Actions with Potential for Significant Impact on the Poor

13. There are two major areas of reform that have direct potential for adverse impact on the poor: (i) public service reform and reform of public sector agencies, and (ii) fiscal reform. They are first discussed in general, and then analyzed in the context of the three scenarios.

D. The Impact of Public Service/Public Sector Agency Reform

14. The major direct impact that public service reform will have on the poor is through retrenchment of public service employees. This includes those public sector employees who would lose their jobs through privatization of some Government services and public sector agencies. It is assumed that those employees at the bottom of the public service structure, even while still employed, would approach what could be considered poverty status. In the context of the direct impact of public service reform. it is this group of poor that is considered.

15. Public service reform will not have a direct or specific impact on the poor any more than the impact on other elements of the society, because retrenchment will extend across all levels of the entire public service. The poor will be the least capable of dealing with this impact they would have the fewest employment opportunities in the face of lost employment, and the fewest personal or family resources to use as a financial cushion. As the dependency ratio in the Marshall Islands is high, with estimates of up to eight persons depending on every wage earner for support, it is expected that retrenchment would have a heavy impact on households and families of public service employees to be retrenched. The impact of retrenchment on the poor would be particularly marked in the modern, monetized, import-oriented economies of Majuro and Ebeye. Moreover, with unemployment highest in Majuro and Ebeye, loss of employment would have particular impact in these areas.

16. In the Marshall Islands culture, it is expected that family members lacking resources will receive support from other family members who have resources available. It is expected that retrenchment and the effect that loss of income will have on retrenchees and their household and family members will result in additional burdens on family members who retain employment.

E. The Impact of Fiscal Reform

17. Fiscal reform will entail expenditure reallocation, the removal of subsidies to public sector agencies, increased effectiveness in public investment, and improved financial management and performance in tax collection. Effects that fiscal reform may have on the poor include fewer employment opportunities because of reduced economic activity previously based on Government expenditure or Government subsidies, increased prices or reduced availability of some goods because of more stringent tax collection, or business activities contracting because of the burden imposed by more stringent tax collection. Private sector firms relying on Government expenditure will be affected negatively. The effect on the poor of fiscal reform will be less than that of public service/public sector agency reform.

F. Three Scenarios

1. Scenario 1: Without PSRP Reforms[1]

18. Under this Scenario, there would be no immediate impact on the poor. However, given the current and projected financial status of the Government, it must be assumed that in the near term, the Government will exhaust its financial resources and will not be able to maintain the public sector. In this case, there will be unplanned forced unemployment in the pubic sector and/or drastic reduction in wages, the Government will not be able to provide the necessary public goods and services, will not be able to pay its accounts and strong social and political reactions will be experienced.

a. Direct Impact

19. With no reform or restructuring to be implemented, there would be no impact on the poor through changes in demand for labor. All employees would retain their employment, welfare levels would not suffer and prices would follow normal market movements. In the medium term, prices would be affected by market reactions to instability that will result from the Government being unable to sustain the public sector. There would be no immediate effect in terms of net public transfers from the Government, or in the Government being able to provide necessary public goods and services. However, in the medium term, the Government will not be able to sustain transfer programs or provision of public goods and services. This would have severe negative impact on the poor.

20. Lack of fiscal reform would not be expected to have an effect on the demand for unskilled labor. Jobs would not be lost and welfare would not be affected. In the longer term, the negative effect of a lack of fiscal reform on the economy and continued poor performance overall, and the fiscal insolvency that will result, would have negative effects on the demand for unskilled labor. Without fiscal reform, the Government will have an increasingly difficult time in securing and making available the resources necessary to support transfer payment and to provide necessary goods and services, and eventually would not be able to do so. The Government already is experiencing some difficulty in this regard.

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[1] Poverty impact assessment matrices for Scenarios 1, 2 and 3 are shown respectively in the attached Tables 1 and 2.

b. Indirect Impact

21. Indirect impact of Scenario 1 would follow the direct effects. No specific impact could be identified in the shorter term, but without reform, a variety of negative longer-term effects with regard to labor demand, prices, transfers and provision of public goods and services will be felt as the Government exhausts its available resources and is unable to sustain the public sector. As transfer payments from the Compact currently decline, such effects already are being felt. The lack of fiscal reform would have a longer term effect on the demand for unskilled labor, in the form of reduced demand within an unstable economy. Economic uncertainly based in expected fiscal difficulties within the Government already is apparent. The lack of fiscal reform and eventual fiscal insolvency will have similar negative effects on prices. In an environment of no reform coupled a lack of economic growth and economic instability, it is likely that inflation will be experienced and prices will rise. The poor would be least capable of coping with such price increases.

c. Macroeconomic Impact

22. The macroeconomic environment similarly would show no immediate impact of the absence of reform. However, it must be assumed that a negative macroeconomic environment would emerge as the Government exhausts its resources and is unable to sustain the public sector. Significant social and economic instability will result, bringing with it a number of severe problems. Continued poor fiscal performance and eventual fiscal insolvency will also affect economic stability, which would discourage investment. Unskilled labor would be the first sector of the labor market to experience a decline in demand. Continued poor fiscal performance will affect the Government's ability to provide transfer payments and essential public goods and services. Any reduction in these areas of Government likely would result in social instability in the short run and a reduction in economic growth opportunities in the longer run.

d. Impact on the Non-poor

23. In Scenario 1 there will be little direct impact on the nonpoor. The nonpoor, however, will suffer, though not to the extent of the poor, from the negative effects of the Government not being able to sustain the public sector. The nonpoor would be better able to cope with any negative effects, and would be better placed to protect and pursue their interests in the face of an adverse environment. In some cases, the negative effects of the lack of reform could force some nonpoor into poverty.

24. Lack of fiscal reform would not have any direct short-term effect on the nonpoor. They would generally be affected by overall effects in each channel. Nonpoor, however, would be better placed to cope with any negative effect. In the longer term, lack of implementation of fiscal reform and continued poor fiscal performance would have severe social and economic effects even for the poor. Some nonpoor could be forced into poverty.

2. Scenario 2: Reform, Without External Assistance

a. Direct Impact

25. Scenario 2 shows a significant negative effect on the demand for unskilled labor. A major loss of welfare for individuals and their households and families would result

from retrenchment without any compensation. This effect will be especially significant in view of the traditional welfare system based on the family, where persons previously supporting other persons no longer will be able to provide such support. With the high unemployment and relatively low state of development in the economy of the Marshall Islands, there would be severe competition for the few alternatives that exist; it is expected that few alternatives actually would exist. The labor market will be forced to adjust to market realities, but the adjustment process will be abrupt and difficult. As the Government does not have the capacity to develop and manage the retrenchment program in an effective and equitable manner, there is no assurance that the poor would not be the most adversely affected in its implementation.

26. Without external assistance, the Government would have difficulty in implementing necessary fiscal reforms. The Government lacks necessary capacity and financial means for successful implementation of reforms on its own. While this would not have a direct impact on the demand for unskilled labor, inadequate or ineffective implementation of reforms would not contribute to any expansion in demand for labor. One specific element of reducing Government expenditure under fiscal reform could be a decline in the demand for labor in enterprises dependent on Government expenditure.

b. Indirect Impact

27. Retrenchment without compensation would result in significant negative indirect effects in demand for unskilled labor. Significant economic and social dislocation among unskilled labor is certain to result as the negative effects of retrenchment ripple through the economy. With the slowing of the economy that would result from the effects of retrenchment, there may be a possibility that opportunities for unskilled labor that did exist may disappear. In view of the traditional system of welfare based in the family, there would be increased pressure on persons who remain employed to provide support for household and family members who become unemployed. The labor market would be forced to become responsive to the realities of the existing labor market, though this would be a difficult, unguided process. As a program of fiscal reform implemented without external assistance could be expected to be inadequate or ineffective, the channels of labor demand, prices, transfer payments and access to public goods and services all would suffer from an unsuccessfully implemented program of reform.

c. Macroeconomic Impact

28. The economic and social dislocation caused by unsupported retrenchment of unskilled labor will result in economic and social instability. It is expected that there will be a major political element to this instability. This would have a negative effect in the Government achieving the positive economic recovery and development envisaged as an objective of the reform program. In any case, the poor would be the first to suffer from the negative effects of macroeconomic instability, and would suffer most. An unstable macroeconomic situation would have negative effects on the market and the price mechanism. Again, the poor would be the least able to cope with any increases in prices or in shortages of essential goods. At the macroeconomic level, inadequate or inappropriate implementation of fiscal reform would have a negative impact. The eventual fiscal instability of the Government resulting from poor fiscal performance would severely affect the economy. In a situation of fiscal collapse and economic instability, it can be expected that demand for unskilled labor would decline.

d. Impact on Nonpoor

29. In a situation of retrenchment without support, for those nonpoor who are retrenched, a new class of poor will be created. It is further expected that this new class of poor will compete with the existing poor for available opportunities; given the previous influence, training, resources, etc., of this newly created class of poor, it could be expected that the new poor would more successful in seizing those opportunities that exist. While the nonpoor would not be affected directly by inadequate implementation of fiscal reform, the nonpoor would suffer the longer term effects. This applies to the channels of demand for labor, prices, transfer payments and public goods and services. In the case of the Government's fiscal collapse and resulting economic instability, it could be expected that the impact on the nonpoor would be significant, forcing some persons who are nonpoor into poverty.

3. Scenario 3: Reform with External Assistance

a. Direct Impact

30. There will be loss of welfare for unskilled labor through retrenchment. This loss of welfare, however, will be mitigated somewhat through compensation payments. Technical assistance to be provided will assist the Government in designing an action plan for the retrenchment program that will be effective as well as equitable. Retrenched persons will be able to survive at a subsistence level.

31. Funds will be available to cover the costs of compensation to retrenchees, preserving access to other Government funds that may have been used otherwise and which represent the resource base for other transfer payments. While the provision of some public goods and services will be curtailed, availability of external assistance could help preserve the resource base needed for the provision of essential goods and services.

32. The direct effect on the demand for unskilled labor likely would be neutral in the short term, but it could be expected that with a stronger fiscal environment and a resultant more stable, productive economy, employment opportunities would increase. With reduced Government expenditure, one specific negative effect might be a reduction in demand for labor in enterprises dependent on Government expenditure. With regard to transfer payments and provision of public goods and services, it could be expected that improved fiscal performance would create a sounder financial base for these services to be provided. Continued provision of transfers and public goods and services would contribute to the overall welfare of the population, particularly the poor.

b. Indirect Impact

33. With regard to unskilled labor, some longer term social and economic dislocation will result from retrenchment. Mitigation measures, however, will help reduce overall impact. There will be increased pressure on persons who remained employed from household and family members who become unemployed. Through mitigation measures and other support to be provided, adjustment and rationalization of the labor market would become an easier process. The compensation package for retrenchees has a cutoff point, and retrenchees will be forced to end their reliance on compensation. As external assistance will be provided for compensation payments, Government resources needed to support other transfer payments and to provide basic public goods and services will be protected. A decline in

welfare will be experienced if necessary transfer payments and public goods and services are eliminated or curtailed, or if user charges are imposed.

34. In addition to creating a more stable fiscal environment for the Government, it is expected that improved fiscal performance would create a more equitable tax burden for the population and more equity in public expenditure; this especially would be to the benefit of the poor. At the same time, however, reduction in Government expenditure could have some impact on the demand for unskilled labor, as private sector activity depending on Government expenditure would be reduced. More effective fiscal performance may cause some longer term increases in prices and may affect the availability of some goods. At the same time, the more stable economic environment that would be created by sound Government fiscal performance could create markets in which prices would stabilize.

c. Macroeconomic Impact

35. Economic and social dislocation caused by retrenchment will be mitigated somewhat. While unskilled labor will suffer first and most from macroeconomic instability, economic recovery and a more stable economic environment will be created more quickly, resulting in new opportunities for unskilled labor. With economic recovery and stability being reached more quickly, a sound basis for Government programs for transfers and provision of basic goods and services will be achieved more quickly. Improved fiscal performance by the Government would contribute significantly to macroeconomic stability and to the development of a sounder economy.

d. Impact on the Nonpoor

36. There will be a loss of income for the nonpoor who are retrenched under reform programs; again, a new class of poor will be created. Mitigation measures would cushion the impact of retrenchment, though it can be expected that the non-poor still may compete with the already poor for available opportunities and resources. The nonpoor would be affected by any changes in prices, transfer payments, or provision of public goods and services. However, with their existing resources as well as with mitigation measures to be provided, the nonpoor will be better able to cope with whatever shocks are encountered.

37. The initial impact on the nonpoor of improved fiscal performance likely would be neutral. Some sectors of the nonpoor may be affected by reductions in Government expenditure. With regard to prices, transfer payments and the provision of public goods and services, the nonpoor would be affected in ways similar to the poor. The difference, of course, is that the nonpoor would be better able to cope with any negative effects as well as take advantage of positive effects.

Impact of Public Service/Public Agency Reform
(Retrenchment, Privatization, Wage Freezes)

SCENARIO 1: No Reforms

	Type of Effect			
Channel	**Direct**	**Indirect**	**Macro**	**NonPoor**
Labor Market	No immediate effect. Future demand for labor will be negatively affected by expected social and economic dislocation	Significant negative effects in longer term	Macro instability likely to occur in the future will negatively affect the demand for unskilled labor	No immediate effect. Nonpoor will suffer from future social and economic instability
Prices	In short-term, prices will follow normal market movements. Prices will be affected negatively by future market instability	Market instability resulting from lack of reforms eventually will cause prices to increase	Macro instability in long-term will result in market instability and price increases	Nonpoor will be affected by any price increases
Public Transfers	No immediate effect. In long-term, government may become unable to maintain program of essential transfers	Negative effects if government becomes unable to provide transfers	Future fiscal failure of Government will make provision of transfers impossible	Nonpoor will be affected by any changes in the provision of transfers
Access to public goods and services	No immediate effect. In long-term, government may become unable to provide goods and services	Loss of welfare if government becomes unable to provide goods and services	Eventual inability of government to provide goods and services will exacerbate social and economic instability	Nonpoor will be affected by any change in provision of goods and services

Total Net Effect: <u>Very severe</u>: Little direct immediate effect, but long-term effects will be financial collapse of Government and severe social and economic instability.

Assumptions about crucial variables: If Government does not act, financial collapse and instability are unavoidable.

Impact of Public Service/Public Agency Reform
(Vacancy Elimination, Retrenchment, Privatization, Wage Freezes)

SCENARIO 2: Implement Reforms without Assistance

Type of Effect

Channel	**Direct**	**Indirect**	**Macro**	**NonPoor**
Labor Market	Major loss of welfare for retrenched employees. No avenue to develop alternative employment skills or for alternative opportunities to develop	Significant economic and social dislocation. Increased family pressure on persons who remain employed. Slowing of economy may cause existing economic opportunities to disappear	Economic dislocation will cause significant social and economic instability. Poor will suffer first and most. Recovery of economy will take longer	New class of poor will be created among retrenched employees. These poor will compete with existing poor for opportunities
Prices	Prices will be affected by declines in consumer-based demand and the overall adjustment process	As consumer-based demand lessens, some prices will rise and some goods may become unavailable	Social and economic instability will affect all aspect of the price mechanism	Nonpoor will suffer from social and economic instability
Public Transfers	Compensation to retrenched employees will not be possible. Government resources still may not be sufficient to maintain transfer payment programs.	Programs of essential public transfers may be disrupted if resources are not available	Social and economic instability will be exacerbated by inability to provide essential transfers	Nonpoor will suffer if transfers are not maintained
Access to public goods and services	No certainty that government will be able to continue to provide necessary goods and services.	Availability of necessary public services may be affected severely by lack of resources	Unavailability of public services will severely affect social and economic stability	Public services will become unavailable or more expensive

Total Net Effect: Severe. Economic and social dislocation without safety net provisions. No technical assistance to ensure that reform program is designed and implemented correctly.

Assumptions about Crucial Variables:

1. Government does not have expertise or resources to implement reform.
2. Lack of safety net provisions will have a very serious negative effect.
3. Without safety net provisions, impact will be particularly severe.
4. Effective reform is necessary for total program to be successful.

Impact of Public Service/Public Agency Reform
(Vacancy Elimination, Retrenchment, Privatization, Wage Freezes)

SCENARIO 3: Implement Reforms with Assistance

	Type of Effect			
Channel	**Direct**	**Indirect**	**Macro**	**Nonpoor**
Labor Market	Loss of welfare for retrenched employees; some mitigation through compensation payments and training. Retrenched workers will be forced to seek other employment opportunities as compensation payment cease	Some longer-term economic and social dislocation will result from retrenchment. Increased family pressure on persons who remain employed	Economic dislocation will be mitigated somewhat. While poor will suffer first and most, a more stable economic environment will be created, leading to faster economic recovery.	Loss of welfare for nonpoor who are retrenched. These individuals may compete with poor for remaining economic/employment opportunities
Prices	Prices likely will rise in the course of the adjustment process	Longer-term effects of reforms and reform process likely will cause prices to rise	Macro stability in long-term will result in faster market adjustments	Nonpoor will be affected by any price increases
Public Transfers	Basic compensation to be paid to those who loose jobs; training and counselling will be provided. Essential transfers can be maintained	Adjustments in transfer programs can be made	Overall program of transfer payments will rationalize as reforms are implemented	Nonpoor will experience some effects of rationalized program of public transfers
Access to public goods and services	Essential goods and services can be maintained	Some goods and services may become unavailable or prohibitively expensive	Program of goods and services to be provided will rationalize	Nonpoor will be affected by any changes in provision of goods and services

Total Net Effect: Significant: Major social and economic dislocation will result from public sector reform. However, without reforms, future social and economic instability will be more severe.

Assumptions about Crucial Variables:

1. Some employees will willingly accept retrenchment if compensation is offered.
2. Compensation will help mitigate negative effects.
3. Reform will be more successful if advice and assistance to Government is available.
4. Assistance will help in readjustment process.