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Impact of the COVID-19 Pandemic on the Federated States of Micronesia: Economic Outcomes and Policy Review

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Federated States of Micronesia

Impact of the COVID-19 Pandemic on the Federated States of Micronesia: *Economic Outcomes and Policy Review*

Introduction

The FSM took strong proactive measures to protect the health of the nation, including closure of its borders. In the early months of 2020, the onset of the COVID-19 global pandemic ravaged the global economy with unprecedented reductions in GDP and rapidly rising unemployment. To reduce the spread of the virus, global travel restrictions were implemented which led to a collapse of international travel. In response to the pandemic the FSM took strong proactive measures—perhaps some of the strongest in the world—to protect the health of the nation, and effectively closed its borders at the beginning of March 2020. While a single case of COVID-19 was reported in Pohnpei, the individual was identified at the border (port) and remained in quarantine until tested negative for the virus, and the entire FSM has successfully avoided any cases of community spread. These policies and the priority placed on public health have served the FSM well.

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

The FSM collaborated with the US Centers for Disease Control to vaccinate the population, but coverage has lagged behind available vaccine supply. At the start of 2021, with the benefit of the US-sponsored program Operation Warp Speed to produce vaccine options effective against the COVID-19 disease, the FSM began rolling out a nationwide immunization program in collaboration with the CDC. Additional supply of China-provided vaccine has also been received. However, coverage has lagged available vaccine supply and has been slow in comparison with the FSM's sister Freely Associated States (FAS) and US territories in the Pacific with only 25 percent of the population receiving a first dose (21 percent fully vaccinated) by end June 2021. While urban centers have achieved higher coverage, difficulties in distributing vaccines to remote locations disbursed over many small islands has proven difficult. Distribution and travel by health officials to these locations will require time to accomplish. Until vaccine coverage reaches a much higher level, the nation will not be able to consider reopening its borders. Economic recovery will remain secondary to protection against the pandemic's severe threat to the population and to the national health system.

National government initiated an economic Stimulus Package to mitigate the impact of the pandemic on affected businesses and individuals. The governments of the FSM entered the pandemic with a mixed fiscal position. At the state level, revenues and expenditures were largely balanced, but with limited reserves to draw upon and limited fiscal space to endure adverse shocks. At the national level, the government has been running a significant surplus reflecting the growth in the Vessel Day Scheme (VDS) fisheries receipts, and the FSM domicile for Japanese companies. About two-thirds of the additional revenues since FY2012 have been saved in the FSM Trust Fund or as uncommitted reserves. At the national level there was thus significant fiscal space to assist the states, affected businesses, and individuals to mitigate the impact of the crisis. In April and May of 2020, the national government announced an "Economic Stimulus Package" and creation of a "Tourism Sector Mitigation Relief Fund" to assist the affected business and individuals reliant upon the tourism and visitor sector.

State governments with limited fiscal space had little or no capacity to respond to the pandemic. At the state level the impact of declining economic activity, especially within the private sector, increased the fiscal drag of the amended Compact's declining transfers. The combined result increased fiscal pressure and has been compounded by persistent under-spending of compact sector funding. Such "carry-over" funding remains available to each state, but only through subsequent fiscal year supplemental awards for "non-recurrent" uses. With limited reserves to offset the deteriorating position, the state governments were severely limited in their ability to respond to the crisis. The states were thus reliant on the national government and donor support to mitigate the adverse impacts of the crisis.

Lack of data on the economy and fiscal outturn for FY20 make assessment of the impact of COVID-19 problematic. This review and update on the earlier Graduate School USA (GSUSA) economic impact assessment[1] starts with a brief overview of the economic performance and fiscal structure and of the FSM in section 2. These isolate key features of the economy and provides important background to the analysis. Unlike the Marshall Islands and Palau there are no preliminary estimates of GDP or the fiscal outturn for FY20 on which to assess the impact of the COVID-19 pandemic on the economy. This results from two factors: (i) difficulties arising from the pandemic and collecting information from the four states of the FSM, and (ii) systemic issues relating to the basis of compilation of the national accounts that have existed for some time, but have now come to a head, as the structural relations in the economy have, due to the pandemic, broken down. The latter issue follows from the lack of information sharing within the national government, an issue that is addressed in the policy section of this *Economic Assessment*.

In the absence of a fully comprehensive data set, the outturn for FY20 has been projected based on information that is available and the results from an model of the FSM economy. Reflecting the available data on which to assess economic performance during FY20 and the impact of the COVID 19 pandemic, the third section outlines the set of assumptions that have been made relating to the economy, both for FY20, FY21, and for the years through FY25. For FY20 although comprehensive economic data is not available, many key variables, relating to fishing, government operations, and other sectors are available and have been drawn upon. During the preparation of this *Economic Assessment* many discussions and meetings were held with FSM officials and stakeholders drawing on their insights to help formulate the assumptions. For FY21, the remaining period of the amended Compact through FY23, and beyond, the economic model[2] developed for the FSM by the GSUSA has been utilized. The section closes out with an outline of the various mitigation programs adopted internally by the

The state governments were reliant on the national government and donor support to mitigate the adverse impacts of the crisis.

[1] See **Assessing the Impact of COVID-19 on the FSM Economy**, Graduate School USA, May 2020.

[2] See **FSM FY18 Economic Review**, Graduate School USA, March 2020, for greater detail of model mechanics.

FSM, and with support provided from the Asian Development Bank, World Bank, the United States, and other donors.

Projections assume the FSM will gradually open its borders in the first half of 2022. Section four outlines the economic impact of the COVID-19 pandemic on the economy and fiscal position in FY20 and FY21. It then outlines a likely path for economic recovery on the assumptions that after the vaccination program is sufficiently complete, the FSM will gradually open its borders to the outside world during the first half of 2022.

The final section focuses on a variety of policy issues that will facilitate economic growth and development after recovery. In the final section, attention is devoted to policy options that the FSM government might wish to pursue to facilitate fiscal and economic stability as the economy emerges from the pandemic. The discussion focuses on (i) statistical monitoring, (ii) private sector issues: the domestic fishing fleet, and the domicile for Japanese captives and major corporations, (iii) financial issues: tax reform, external debt, the FSM Trust Fund and Social Security, (iv) the SOE sector: ICT issues and PetroCorp, and (V)infrastructure and long-term planning.

Economic and Fiscal Structure, and Performance of the FSM economy

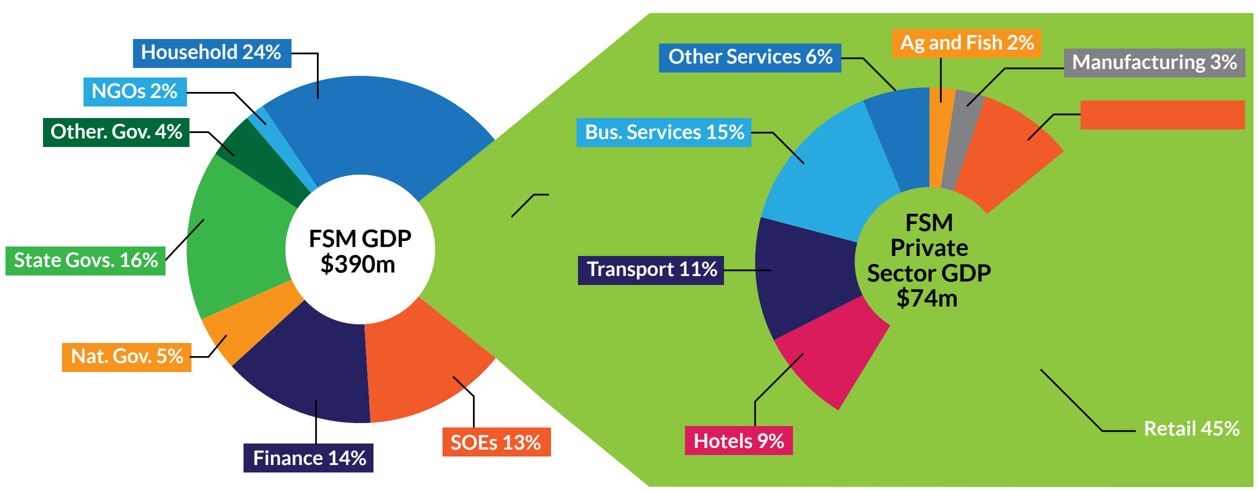
In order to interpret the results of the *Economic Assessment* of the impact of the COVID-19 pandemic, the recovery and trends through FY25 and after the end of the amended Compact, it is beneficial to review recent performance and structure of the FSM economy. This analysis[3] provides background as to the likely response of the economy given the assumptions outlined in this report.

Economic Structure

The private sector is small and underdeveloped in the FSM. Figure 1 indicates the structure of the economy by institutional sector and the composition of the private sector by industry. The private sector represented an average of 22 percent of GDP during the FY17-FY19 period. The size of the private sector is smaller than the FSM's two sister FAS, the RMI and Palau, where the private sector represents 33 and 50 percent

[3] See also **FSM FY18 Economic Review**, Graduate School USA, March 2020, for an in-depth analysis of economic structure and performance.

Figure 1 FSM Institutional Structure of the Economy, FY17-FY19, 3-year average



of GDP, respectively. The government sector comprising national, state, municipal and agencies represents 25 percent, falling between the RMI and Palau where the government represents 30 percent and 24 percent, respectively. Despite the national and state government bureaucracies the share of government in GDP is lower in the FSM than in the RMI.

The household and informal sector is relatively large in the FSM reflecting the slower rate of economic growth and transformation of the economy. As an indirect measure of development of the modern economy, production of the household sector in both informal and non-marketed or subsistence production in the FSM represents a large 24 percent compared with 13 percent in the RMI and 9 percent in Palau. Palau clearly has the most developed and modern economy with a relatively large private sector, whereas the FSM has a large informal sector. The RMI on the other hand has greater integration into the cash economy than the FSM but has relied on the public sector as the major engine of growth.

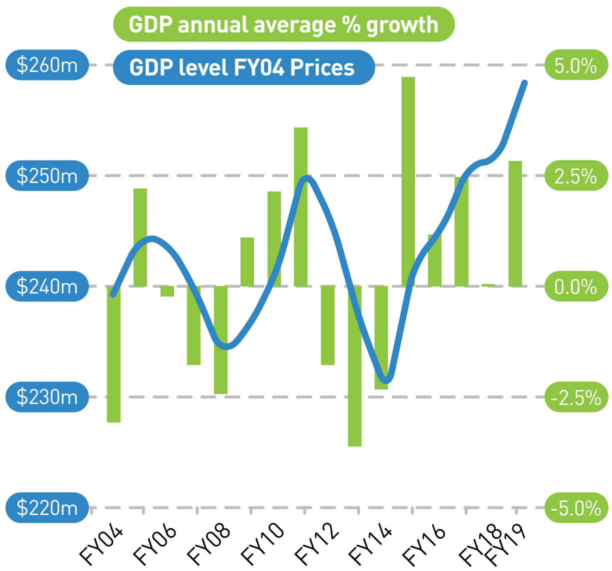
The small private sector provides services to other sectors in the economy and is dominated by retailing. Figure 1 also breaks out the structure of the private sector by industry. The FSM has been unable to develop those industries in which it is presumed to have a comparative advantage: agriculture, fisheries, and tourism. In the RMI fisheries represents 37 percent of private sector activity, and in Palau the tourism economy is 46 percent of private sector activity. The private sector in the FSM is largely comprised of dependent services providing support to the public sector. The largest private sector activity is retail representing 45 percent of GDP, with the next largest being business services and transport. During the business cycle the private sector growth has typically mirrored that of the public sector.

Economic Performance

Failure to develop a competitive private sector has resulted in weak economic growth. The

Figure 2 GDP level (FY04 prices) and annual % growth

FSM economy averges 0.3 percent annual growth between FY04 and FY19



FSM's economic performance has been weak during the amended Compact period, with annual growth averaging 0.2% from FY04 to FY19, see Figure 2.[4] This is considerably below the FSM's sister FAS, the RMI, which grew by an average 1.3% growth, and Palau which grew by 0.9 percent. The weak performance in the FSM reflects not only natural disadvantages such as the small size of the country and its remote geographical location common to the other FAS, but also an uncompetitive private sector policy environment, and the failure of the economy to foster new private sector industries in areas of potential comparative advantage. Economic performance has been dominated by a large public sector, supported by the economic provisions of the amended Compact. With the drag on the economy caused by the declining inflation-adjusted value of Compact sector grants due to the annual decrement and lack of full inflation indexation, much of the economy has been in a perpetual state of decline.

[4] Data is presented over the FY95-FY18 period; data quality improved in FY95, and the series is considered more reliable.

Growth improved from FY15-FY19 reflecting booming sovereign rents from fishing fees and the offshore domicile for Japanese companies and the increased public spending those revenues supported.

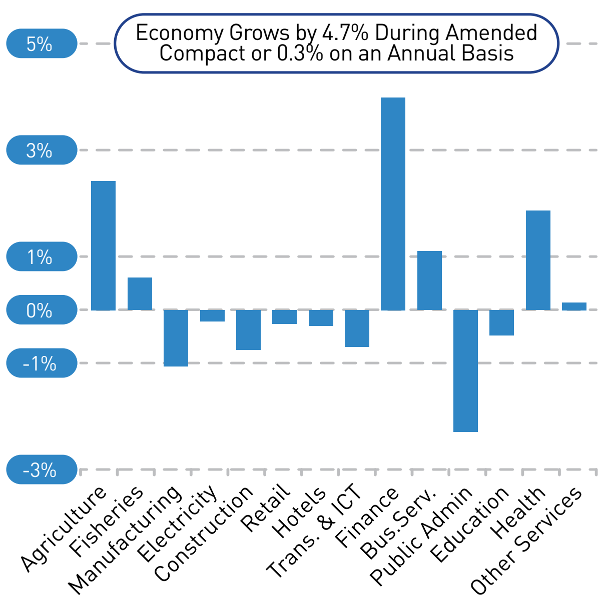
Higher growth could have been attained if the FSM had chosen not to save by adopting the RMI approach to public sector-led growth. It is worth noting two factors that would have resulted in higher economic growth results over the amended Compact period—though such growth that might have occurred would have followed more closely the public sector-led growth of the RMI rather than the private sector-led growth of Palau. Those two factors are: (i) the FSM national government has effectively sterilized two-thirds of the revenue windfall it has experienced since FY12, and (ii) the infrastructure program under the amended Compact period is projected to spend less than half of annually available funds and end the period in FY23 with, perhaps, over $260 million of unexpended infrastructure fund reserves. Both factors are discussed further in the policy section of this *Economic Assessment*. Notably, both factors provide an opportunity to improve the FSM's economic prospects going forward.

While the trend in economic performance has been nearly flat the yearly results have been highly volatile. Figure 2 also indicates a high degree of volatility and periods of growth and contraction reflecting the level of Compact grants received from the U.S. During the initial period, the FSM economy contracted sharply as the economy underwent adjustment to the last stage of Compact I and the final step-down in funding. With the reforms complete and two years of "bump-up" funding the economy grew for a period, before once again contracting as a result of adjustment to lower levels of resources from the amended Compact. During FY09-FY11 the economy benefited from greater utilization of the Compact infrastructure grant and a series of US Federal Aviation Administration (FAA) airport renewal projects. However, failure of the FSM and U.S. to agree on the use of the infrastructure grant led to a moratorium on its use. Further the largest FAA projects come to an end and the economy went through a further period of sharp contraction, FY12-FY14. Growth improved over the last few years, FY15-FY19 reflecting booming sovereign rents from fishing fees and the offshore domicile for Japanese companies and the increased public spending those revenues supported.

Both construction and public administration have placed a drag on growth during the amended Compact. Figure 3 indicates that finance was a main contributor to maintaining the level of economic activity, reflecting both growth of the banking sector and the offshore FSM domicile for major Japanese corporations and captives. Agriculture, mainly subsistence for home consumption, was also a large supporting sector. This reflects the

Figure 3 Contribution to GDP growth by industry

Agriculture, fainace and health are main contribuitors to growth as construction and public administration contract

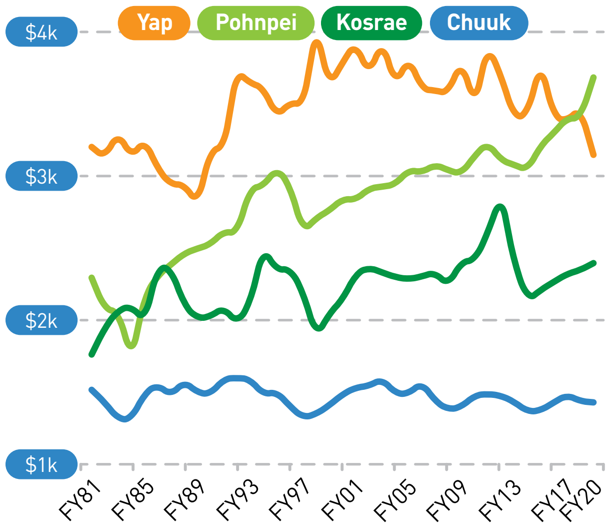


A critical characteristic in the development and political economy of the FSM is income growth and income differences between the four states.

stagnation in the economy and lack of modern sector development. After initial growth in education services reflecting additional funding through the Compact, education has leveled off. However, health also a beneficiary of the Compact has continued to grow. The main drag on the economy has been adjustment of public administration to lower levels of funding under the amended Compact.

Figure 4 GDP per capita (FY04 prices) in Chuuk, Kosrae, Pohnpei and Yap

GDP growth averages 1 percent in Pohnpei but other states stagnate: large state GDP per capita differences



State Performance and Income Disparities

Significant divergence in state level economic performance and income levels has occurred. A critical characteristic in the development and political economy of the FSM is income growth and income differences between the four states. Figure 4 indicates GDP per capita growth for all four states since FY81. During the whole period Pohnpei state grew by an average of 1.2 percent comparable to the RMI and Palau. However, the other three states languished: Chuuk per capita levels fell by 0.1 percent, Kosrae grew by 0.5 percent and Yap by 0.4 percent. GDP per capita levels are also widely divergent with Pohnpei now averaging $3,700, Yap at $3,100, Kosrae at $2,400, or 35 percent below Pohnpei, and Chuuk at $1,400, or 61 percent below Pohnpei.

The reasons for the divergence have long been debated, but amongst the key explanations has been the Compact distribution formula that favors the smaller states and the location of the National government and international agencies in Pohnpei. Geography, cultural cohesiveness, the quality of governance, and policy implementation in each state and the near total absence of federal programs to counteract disparities cannot be ignored as potential contributing factors to such wide and widening income levels across the four states. While differences in long-term economic growth performance likely rely more upon the quality of governance and policy regime in each state, the difference in income levels could be directly affected through FSM domestic poverty alleviation policies and programs and/or donor-supported investments. Donor support would likely increase the likely success of such poverty-focused policies and programs if explicitly supported by FSM authorities.

Fiscal Structure

Sovereign rents have grown rapidly and now represent close to half of all FSM revenues. Figure 5 indicates the structure of revenues by type. In more developed countries tax revenues represent the vast majority of government revenues, but in the FSM tax effort is very low and represents only 14 percent of the total. The tax regime is based on an outmoded regime inherited from Trust Territory days that lacks buoyancy and is ripe for reform. The most

Figure 5 ***National and State governments revenue sources, FY16-FY19 average***

Major revenue sources comprise Compact grants and soverign rents, while taxes are minor

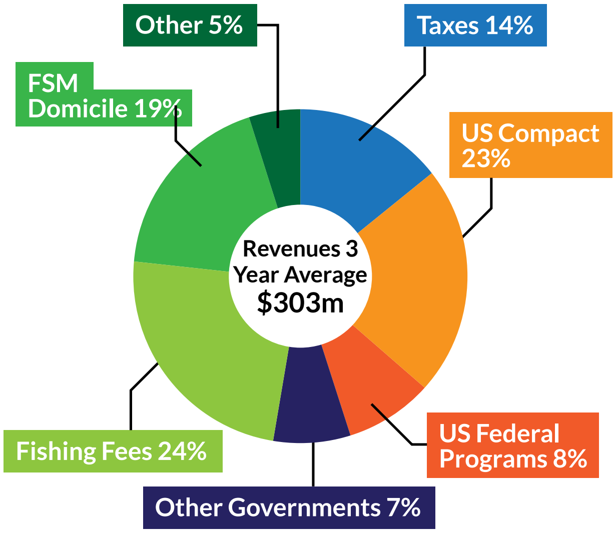
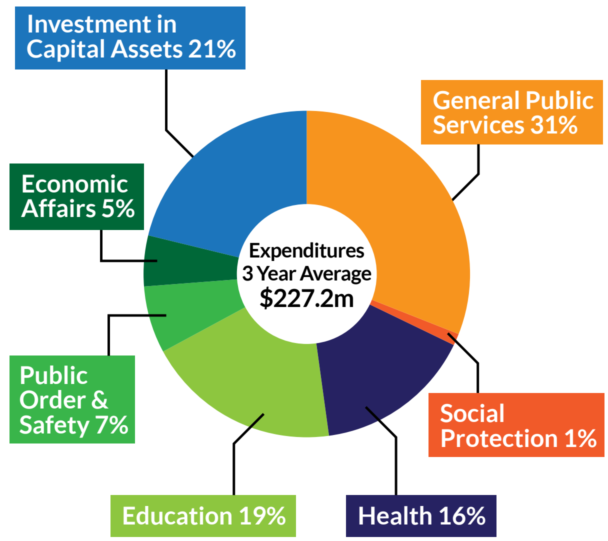


Figure 6 ***National and State Governments, expenditures by function, FY16-FY19 average***

Allocation of expenditures to capital assets is high given the low performance of the economy



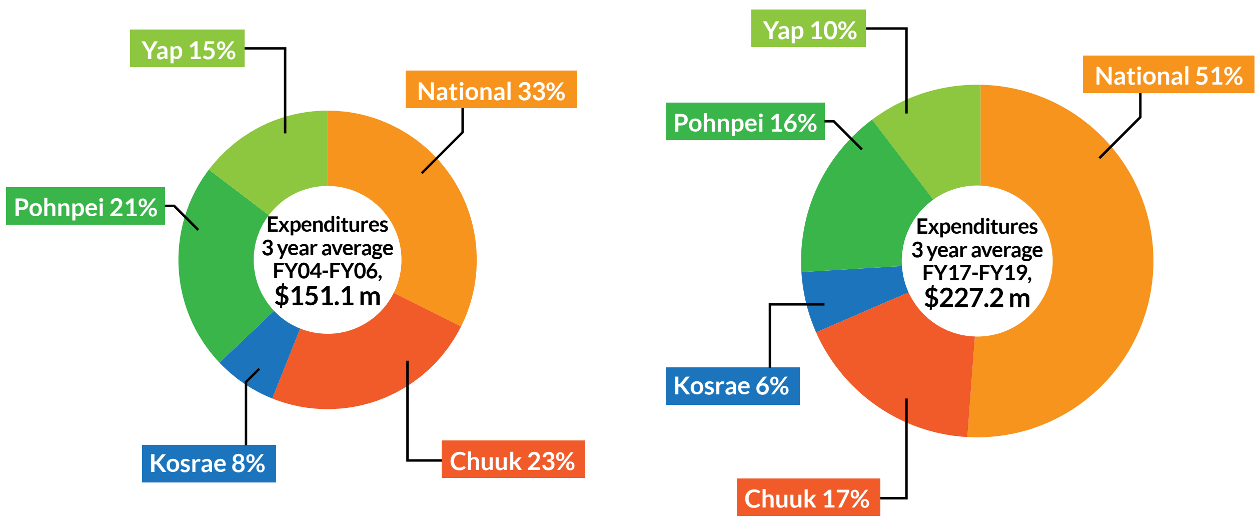
important source of revenue, grants, represents 38 percent of the total, but is either fixed in nominal terms or declines reflecting the lack of indexation of the Compact sector grants. Clearly, the economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants, federal programs, multilateral, and bilateral grants. Taking grants and certain taxes together, over half of revenues, are inelastic with respect to GDP. The major buoyant source of revenues, that has grown very rapidly in the last few years, is represented by sovereign rents: fishing fees derived from Parties to the Nauru Agreement and implementation of the Vessel Day Scheme (24 percent of revenues), and the FSM domicile for Japanese corporations (19 percent of revenues). Other government fees, sales, and investment earnings account for 5 percent.

The structure of government expenditures is evenly balanced between the normal functions of government. Figure 6 provides a broad picture of government expense by function averaged over the FY17-FY19 period. Public services are relatively evenly spread across the normal functions of government. Two sectors, education and health, are predominantly funded through the Compact and are delivered at the state level; they represent 19 and 16 percent of expenditures, respectively, but remain relatively small despite the focus of the amended Compact. Public administration represents 31 percent and represents a large slice of government activities. Economic affairs is small at 5 percent, but investment in capital projects is high at 21 percent. The high proportion of investment in capital assets, despite the collapse in the use of the infrastructure grant, largely reflect recent spending on public projects from national government funds, although a substantial pipeline of World Bank activities led by ICT

Sovereign rents now represent 43 percent of revenues and form the major element of revenue surpassing Compact grants.

Figure 7 National and State Governments, share of expenditures

National government expenditures dominate public expenditures



investments and FAA airport improvements are included. The implied investment capital to output ratio (ICOR), given the weak performance in the economy, indicates a low level of efficiency and productivity of investment.

Public expenditure levels at the national and state governments have changed greatly as revenues accruing to the national government have grown rapidly while state revenues have languished. Figure 7 provides an indication of the share of each state in public expenditures since the start of the amended Compact. The average level of expenditure during the FY04-FY06 period was $152 million with the national government responsible for 33 percent and the remainder being spread over the four states. These proportions have Changed greatly since this time and the national government now directs more than half of all expenditures. During the period, state government expenditures have grown by 5 percent while national government expenditures have grown by 145 percent. Given that service delivery predominantly takes place at the state level the implications for service delivery are profound.

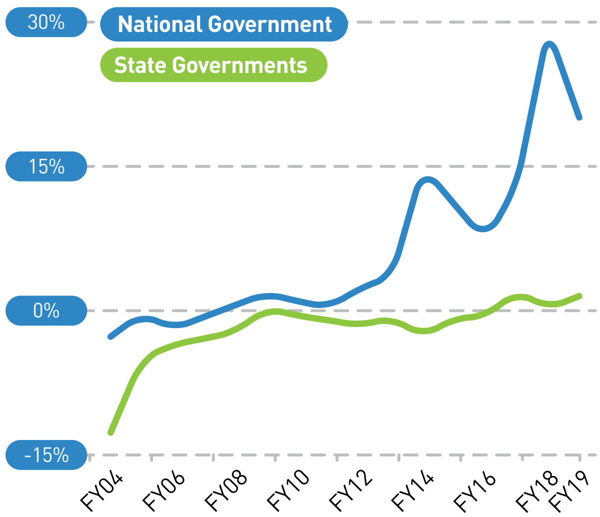
Fiscal Performance

Fiscal balance has been maintained by the four state governments; however, service delivery has been severely constrained at the state government level. The FSM government comprises four state governments and a national government, with much of the responsibility for public service provision—including education, health, and public safety—held primarily by the state governments. With declining inflation-adjusted Compact sector grants and little or no growth in domestic revenues at the state level, service delivery and public expenditures have been severely constrained. Despite these challenges, the state governments have adopted a prudent approach to fiscal policy and have maintained fiscal balance, see Figure 8.

National government runs large fiscal surpluses. At the national government level, fiscal conditions are markedly different. In addition to tax revenues shared with the state governments, the national government benefits from the receipt of sovereign rents from fishing royalties under the Parties to the Nauru Agreement and implemented through the Vessel Day Scheme. Fishing royalties have grown steadily from a level 5% of GDP at the start of the amended Compact, to an average of

Figure 8 Fiscal balance state and national governments, percent GDP, FY04-FY19

State governments maintain fiscal balance while national runs large surpluses



21% of GDP during FY15 to FY19 with minimal volatility. In FY19 receipts from fishing licenses were $73 million. The national government has also established an FSM tax domicile, primarily for Japanese captive insurance and major corporations. While this normally represents less than 2% of GDP, its value to the national revenue base spikes periodically. In FY18 and FY19, for example, it averaged 24% of GDP due to receipt of large tax declarations (capital gains) by major corporations. The combination of fisheries revenues and the tax domicile revenues has resulted in large fiscal surpluses for the FSM national government. During FY15-FY19 this large structural surplus averaged 19% of GDP, peaking at 30% in FY18.

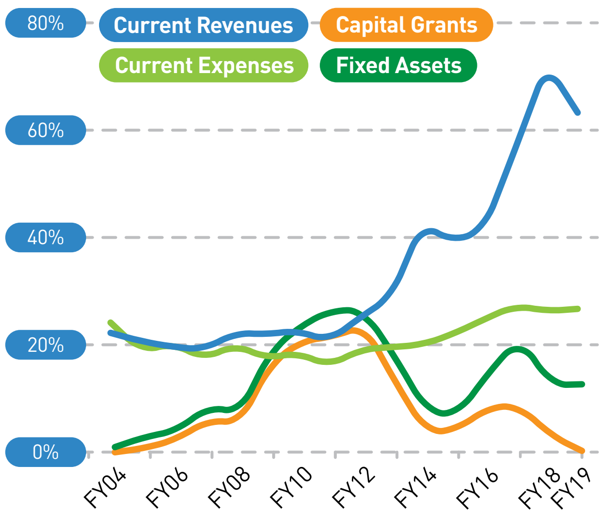
Large fiscal surplus has supported rapid growth in the nation's own FSM Trust Fund. The large increase in resources has been utilized in two major ways. Firstly, and most importantly, the FSM has created a national trust fund (FSMTF) and increased its holdings of uncommitted funds. About two-thirds of the additional resources have been allocated to the fund or remain unspent. At the end of March 2021, the FSMTF is estimated to be close to $350 million, a significant—and impressive—achievement. Under a series of public laws, the national government has specified annual ongoing commitments to the fund, including 20% of domestic taxes, 50% of corporation taxes from the domiciled captive insurance and large corporations' sector, and a further 20% of fishing fee revenues. The national government is thus committed to adding about $24 million annually to the fund, under conservative estimates, although during the COVID-19 pandemic period a portion of these funds has been diverted into the economic stimulus package and tourism sector mitigation relief fund.

Fiscal surplus has enabled large growth in congressionally based projects and increases in use of goods and services. Second, the increase in resources has permitted significant growth of national government congressionally specified projects and increased national government expenditures on goods and services, see Figure 9. Since these expenditures are non-recurrent in nature, the true level of discretionary fiscal space and underlying structural surplus available is considerably larger than that represented as the annual surplus in the fiscal statistics. The national government has forsworn its 10% share of Compact operating sector grants since FY2015, to the benefit of the states. A portion of the funds dedicated to the FSM Trust Fund are deposited into state sub-accounts equivalent to 20% of each state's share of national taxes. While it might be argued that the increase in the FSM's resources has represented a lost opportunity in service delivery at the state level, the national government has purposely avoided a destabilizing rise in state-level recurrent expenditures which would surely be

> *At the end of March 2021, the FSM's own Trust Fund is estimated to be close to $350 million, a significant—and impressive—achievement.*

Figure 9 National government: current revenue, expense, capital grants and fixed assets

Revenues grow rapidly as capital grants fund fixed assets and projects



unsustainable after FY23 in the—now seemingly unlikely—event of an unfavorable outcome of the on-going Compact renewal negotiations.

Assumptions behind the analysis, mitigation, and donor assistance

Travel Restrictons

Projections are based on core assumption that travel limitations will remain in force though much of the first half of-2022. The previous section discussed recent economic and fiscal performance of the economy and important structural considerations upon which the analysis of the impact of the COVID-19 pandemic is made. This section outlines the various assumptions that are drawn on in the projections. The introduction indicated the challenge the lack of comprehensive data presents to projecting the nation's recovery. While a full set of statistical information is not yet available for FY20, some data sources are available, and these have been used. The estimates for FY20 thus are based on a hybrid of actual data and projections. The core assumption is that travel restrictions will not be lifted until the latter part of the first half of FY22 and therefore the full force of the COVID-19 pandemic will be felt throughout FY21. These projections have assumed that in FY22 production levels of the affected sectors recover by one-half of their normal levels and are fully recovered by FY23.

Agriculture

Agricultural production was reported to have grown in the early stages of the pandemic but then to have fallen, perhaps due to large social benefits. Agriculture in FSM occurs predominantly at the household level, for subsistence and local sale. There is some export of local crops, mostly by air cargo and betelnut (from Yap) typically carried as checked baggage, that cannot resume without restoration of passenger air service from United Airlines. Yap exports of betelnut may be shifted in some measure to air cargo on the limited United Airlines flights and on the dedicated APA cargo charter flights with added costs reportedly passed on in the Guam and Saipan markets. The impact of the pandemic on agriculture has been mixed. In the initial phases PetroCorp reported growth in the supply of husked coconuts to their existing coconut processing unit in Pohnpei. However, after the various mitigation programs, US-funded unemployment benefits and ADB support to low-income households, the supply of coconuts in Pohnpei is reported to have fallen by 7-10 percent. While there remains uncertainty as to the apparent reduction in labor effort, there have been two countervailing forces: an initial increase in agricultural production due to reduced earning possibilities, and a subsequent reduction in labor supply and production perhaps due to large unemployment and social benefits to households, and some out-migration.

Fisheries

Fishing activity in the FSM is based on a multitude of different activities. The fisheries industry in the FSM comprises a set of activities: household subsistence, small scale fishing producing small volumes of fish for exports utilizing ice chests and coated cargo boxes on commercial flights, purse seine operations in Pohnpei and Yap, shore-based support to the longline industry in each state, except Chuuk, and the operations of the National Oceanic Resource Management Authority (NORMA). Export of fish on commercial flights from small scale fishing activity is projected to have declined due to reductions of flights disembarking from the FSM.

After a weak year for the two resident tuna corporations fish catch is reported to have improved in FY20 and projected stable thereafter. The export of skipjack tuna caught by Caroline Fisheries Corporation based in Pohnpei rose to record levels in FY19 and is anticipated to return in FY20 to more normal levels falling by 33 percent based on data reported by CFC. This level is projected to remain unchanged through the remainder of the projection period. At Diving Seagull Fish based in Yap fish catch was significantly down in FY19 and recorded negative value added. In FY20 production data indicates a more favorable

> *Fish catch is projected to return to normal levels in FY20 and projected to remain stable thereafter.*

year, return to FY18 levels, and is projected on long-run trend thereafter. The shore-based Luen Thai transshipment service for export of sashimi grade tuna is also projected to continue unchanged—but completely reliant upon Asia-Pacific Airlines (APA) cargo flights to continue operating under any prevailing COVID-19 travel advisory. The contribution to the domestic economy from this latter activity is quite small.

NORMA's observer program was placed on hold but participants were provided alternative jobs or support through CARES. Unlike fisheries in the RMI, FSM management of the fisheries industry is supported through NORMA—a component of the FSM national government[5]. While this Economic Assessment does not anticipate that NORMA's administrative activities will decrease, the temporary closure of the observer program which monitors the fish catch of the purse seine fleet will result in loss of revenues to the national government. NORMA has assigned shore-based tasks to some of its observers with others placed on unemployment program benefits; so there has not been the loss of income originally anticipated for the affected individuals. As per the United Nations System of National Accounts (SNA), fishing rights/VDS revenues are treated as property incomes which are additional to—rather than part of—gross domestic product.

After considerable uncertainty at the start of COVID-19, the outlook for the skipjack industry has improved and looks considerably more stable. Of critical importance to the FSM has been the rapidly growing source of funds from the Vessel Day Scheme of the Parties to the Nauru Agreement (PNA). The low prices of tuna

[5] As a result, the direct contribution of NORMA to GDP is accounted for under the national government.

experienced at the end of 2019 coupled with travel restrictions at the start of the pandemic reduced demand for vessel days and placed downward pressure on VDS daily rates as some operators attempted to return days. However, prices firmed at the start of 2020 and by mid-2021 returned to $1,280 slightly below the past 5-year average of $1,421 per day.

The FSM has been increasing its Party Allowable Effort and has sold all days for 2021. The FSM has been allocated over 7,000 fishing days of Party Allowable Effort under the PNA in recent years, but the trend has been moving upwards with just under 8,000 allocated in 2021. The recent events and uncertainties have led to greater caution with purse seine operators as they have held back purchasing days until later in the year. At the start of COVID-19 the skipjack industry was in a considerable state of flux and uncertainty, but events have firmed, and the future now looks more stable. NORMA reports having sold its total allocation of days in both 2020 and 2021 and while not fully achieving past levels of fishing fees and royalties, it is not anticipating any significant reduction.

Hotels and Restaurants

The tourism industry represents only a small proportion of the FSM economy. Tourism is not large in the FSM and the hotel and restaurant sector accounted for only 1.7 percent of Gross Domestic Product (GDP) during FY17-FY19. Hotels, which cater to both visitors from overseas and interstate FSM travelers, are now running virtually empty. Only about 10 percent of the output of the hotel and restaurant sector is derived from domestic demand from in-state residents. With minimal out-of-state travelers, sector output is projected to fall to exceptionally low levels.

Construction

Construction activity had fallen to very low levels by the start of the pandemic. With the drop in FAA projects and minimal domestic expenditures from the infrastructure sector grant under the amended Compact, the contribution of construction to the economy had fallen from 6.6 percent during a peak in FY11 to a modest 1.6 percent of GDP in FY19. A pending boost in multi-lateral donor funded projects was likely to turn this around in FY20 but has been delayed by the pandemic. While there are some significant People's Republic of China grant funded projects, including the recently completed Chuuk government buildings, and the planned national conference center and Pohnpei state administrative building renovations, these mostly utilize temporary Chinese labor and will not significantly boost GDP during the current pandemic.

Donor projects are not anticipated to increase demand for construction during COVID-19. Current World Bank projects in the maritime sector involving port development and resilient road development ($80 million) will take time to design and are not anticipated to begin until after the pandemic. Other World Bank projects in ICT ($35 million) and energy ($20 million) will be slowed as a result of the pandemic. Similarly, ADB projects in alternative energy ($15 million), and water and sanitation projects (initially $5 million) have yet to reach the design stage and are also unlikely to favorably impact the FSM economy during the COVID-19 pandemic.

Recovery in the construction industry is not anticipated until well into the recovery. Current travel restrictions constrain travel to the FSM of specialist engineers and project personnel. The FSM government has arranged for approximately 60 seats on a dedicated flight in September 2021, to allow for technical experts to arrive and then work after quarantine. International supply shortages and bottlenecks of construction materials are also reported, and prices have risen. Construction of the FSM PetroCorp's coconut processing project in Tonoas, Chuuk, has suffered delay and is largely on-hold until materials and key construction engineers can travel to the state. The current projections assume that construction output will remain at the current low levels until well into the recovery period.

> *Transport and hotels are the main sectors impacted by COVID-19, while strong construction demand has been frustrated by critical supply shortages.*

Transport and Communications

The travel and transshipment sub-sectors are among the more significantly affected industries. The transport and communications sector includes both public sector and private sector components. The travel and transshipment sub-sectors are among the more significantly impacted industries in the FSM economy. Affected activities include local interstate shipping, port and airport operation, shore-based airline operations, on-shore bunkering and resupply[6]. Tourism operators such as diving, surfing and ground transport are also included, albeit at a smaller scale.

Private sector transport industry projected to fall by 70 percent in FY21 compared with pre-pandemic levels. The impact of flight reductions combined with recent travel advisories have restricted purse seine fishing vessels from docking. Initially, each vessel was required to transship its catch outside the reef. At the present time only FSM domestically flagged vessels are permitted to dock in FSM ports while arrangements for other vessels to anchor at port in Kosrae, Pohnpei and Yap are being established. Current projections indicate that output is likely to fall by 38 percent during the two-year period of FY20 through FY21, as compared to FY19. Measuring just the private sector components of the entire sector, the decline is close to 70 percent compared to FY19.

[6] Ticket and cargo sales by foreign airlines are treated as service imports and are not considered part of domestic gross domestic product.

Mitigation Programs and Donor Assistance

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

- State and national government core operations.
- National government economic stimulus program and tourism sector mitigation relief fund.
- U.S. and other donor health assistance programs
- U.S. CARES Act and unemployment assistance.
- ADB COVID-19 Pandemic Relief Option.

State governments have been required to adjust to reduced revenues and maintenance of core operations without direct national or donor support. The analysis has assumed that there will only be minor changes to pre-pandemic levels of core government current operations or public expenditures at either state or national level. Further, it is not anticipated that there will be any transfers from the national to the state governments to support operations due to reductions in domestic revenues and reduced demand in the state economies. As of July 2020, the FSM Congress passed a law enabling each state to access the 20% share of national tax revenue-sharing dedicated to each state sub-account of the FSM Trust Fund to respond to COVID-19 impacts. Absent the uptake of this access the state governments would be required to make expenditure adjustments to both reduced domestic revenues and the fiscal drag of the annual decrement and lack of full indexation of the amended Compact. However, there is an implicit assumption that budgets for travel, utilities, fuel, and other areas where spending would likely decline due to pandemic circumstances will be used to offset and shift to areas of increased spending needs. We await a review of financial audits to confirm the adjustment mechanism(s) of each government.

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

FSM Econmic Stimulus Package

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

FSM puts together funding of close to $15 million for the TFMRF. In addition to the $1m of Congressional funding, resources normally earmarked for the FSM Trust Fund as of April 2020 through the remainder of FY20 were diverted to the TSMRF. This included the 20 percent fishing fee allocation and 50 percent allocation of revenues derived from the FSM domicile for Japanese captives and major corporations. This was estimated to amount to about $9 million. In addition, a further $0.5 million was diverted from the NORMA project development fund, coupled with $3 million out of the $6 million of resources provided by the ADB under the Pacific Disaster Resilience Program. The total thus secured by the FSM for the TSRMF was close to $15 million.

Utilization of TSMRF has benefited a limited number of businesses but should provide funding for the tourism sector through the end of FY22. As of January 2021, 157 businesses across the FSM had collectively benefited from $3.8 million of assistance. The rate of drawdown from the fund over the 8 months of its operation was close to $0.5 million a month, indicating the fund would be able to sustain support through the end of FY22; but only if the current lapse date of September 30, 2021, is extended.

Health Mitigation Programs

FSM was the beneficiary of a large donor response to develop a health response framework. At the onset of the crisis the FSM national government initiated an FSM COVID-19 Response Framework to prepare the nation with a series of steps to mitigate the impact should the FSM become subject to the virus. Donor support for the program was immediate and strong with the US providing the majority of health-related grants: with $7.7 million under an OIA TA from the US CARES Act, $7 million of unspent Compact sector grants, plus a series of other smaller federal programs from CDC, etc. in all totaling about $29 million. Further health related funding was available from the World Bank of $2.5 million and $5.0 million from the ADB. Given that health services in the FSM are delivered at the state level the vast majority of the funds, 90 percent, was utilized by the four state governments.

US Unemployment Benefits- CARES Program

CARES Act unemployment benefits generated significant benefits to affected FSM workers. In common with the other Freely Associated States, FSM citizens were made eligible for unemployment support from the US government under the US CARES Act. The program has provided two forms of benefit: the Federal Pandemic Unemployment Compensation (FPUC) and Pandemic Unemployment Assistance (PUA)[7]. The FPUC was initially awarded at $600 a week for four months April through July of 2020. A second phase of the FPUC was awarded from 6 December 2020 through early September 2021

[7] See **https://dofa.gov.fm/opua/**

at $300 a week. The PUA has been available continuously from July 2020 onwards and is set to expire in September 2021. A benefit of $166 a week has been awarded during the period. Initial funds of $36 million were awarded and despite some technical issues related to the drawdown process, that full amount remains available to the FSM. In the modeling framework the projections of unemployment are multiplied by the CARES Act unemployment benefit rates to generate the impact on household incomes.

ADB COVID-19 Pandemic Relief Option (CPRO)

ADB grants $14 million to the FSM to support Livelihoods. The ADB supported the FSM's Health and Livelihoods Support Program (HEALS) sub-program of the CPRO through a grant of $14 million to the FSM to support business and low-income and vulnerable households affected by the pandemic. ADB also granted a further $6 million to replenish the Disaster Relief Fund. The CPRO contained a series of sub-programs:

1. A concessional line of credit through the FSM Development Bank of $3 million to provide support to 200 SMEs.
2. A cash transfer program of $7.0 million to low-income households not beneficiaries of the US CARES Act.
3. A food security program of $1.0 million for community groups to enhance food production through training and distribution of materials.
4. Community based small grants of $2 million for NGOs and civil society to enhance COVID-19 awareness.
5. Financial assistance to vulnerable groups ($1.0 million) for medical expenses, electricity subsidies, solar lamps, and clinical management of family violence.
6. Cash for 900 stranded FSM citizens ($1.2 million funded by the FSM).
7. Temporary unemployment benefits (0.4 million funded by the FSM) for foreign workers not eligible for CARES Act benefits.

Uptake of the cash transfer program for low-income households has been described as rapid. The funds for the CPRO were not received until FY21 and in the modeling framework has assumed those funds to be distributed on a 75-25 basis between FY21 and FY22 for household related expenditures and 50-50 for the FSMDB. The uptake on the cash transfer program has been reported as rapid, with applications leading to over-subscription and all funds committed during FY21. As the description of the program outlines, the benefits will have a significant impact on low-income households.

Economic and fiscal impact and recovery through the end of the amended Compact period

The FSM economy is not expected to fully recover until FY23 but a favorable outcome to Compact renewal is projected although downside risks exist. This section attempts to estimate the likely impact of the COVID-19 pandemic in FY20, FY21 and through FY25. It has been assumed that the economy will not start to recover until well into 2022. This reflects the slow roll out of the vaccination program and cautious nature of the FSM to reopening the economy to the outside world. The projections have assumed that the economy will be on the recovery in FY22 but will not return to pre-pandemic levels until FY23. FY23 is the last year of the amended Compact's economic assistance terms and uncertainty exists over the outcome of negotiated conditions for a further period of renewal. This *Economic Assessment* has projected a favorable outturn and growth in the economy reflecting supportive financial policies and growth in both donor and US projects. Downside risk exists should a negotiated package be agreed but not passed into law by the US Congress. Such a result would make funding and program activities uncertain starting in FY24 and would not be unprecedented. Palau waited more than seven years after reaching mutual agreement with the US in 2010 before a (modified) agreement was approved by Congress during FY18.

The current projection of a 5.0 percent decline in GDP over the period from FY20-21 indicates a reduced level of impact from prior projections... arising from effective impact of FSM-managed mitigation and stimulus programs.

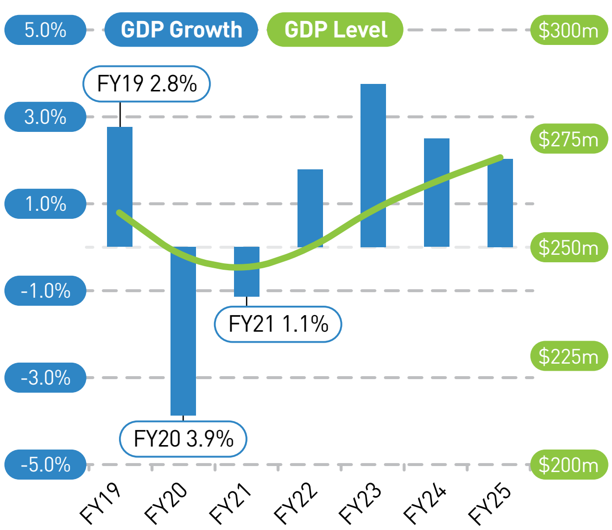
Economic Impact

The FSM economy is projected to contract by an overall 5.0 percent in FY20-21 compared with FY19. The economic impact of COVID-19 on the FSM economy is shown in Figure 10. Projections indicate the COVID-19 pandemic will cause a 3.9 percent drop in GDP in FY20 and a further 1.1 percent reduction in FY21-a combined reduction of 5.0 percent over the two-year period. The earlier economic impact assessment conducted in May of 2020 projected a reduction in GDP of 4.9 and 2.0 percent in the two years, respectively. The current projections indicate a reduced level of impact mostly arising from the effective impact of FSM-managed mitigation and stimulus programs.

Economic impact of COVID-19 has been one of the more severe periods of the amended Compact period. Notably, the total loss to the economy projected during this period is one of the more severe experienced by the FSM economy during the amended Compact period since FY04. However, the various mitigation programs have had a significant impact in reducing the negative impact on the economy, even though some elements of the overall response program did not affect GDP directly.

Figure 10 Projected GDP level and growth

Economy worst hit in FY20 with recovery postponed till FY22



The $29 million health sector programs to prepare the FSM for a possible COVID-19 community outbreak mostly impact the level of government expenditures and demand for imported items such as PPE, medicines, ventilators, etc. The FSM's own internally generated stimulus package and tourism sector mitigation relief fund of $15 million provides cash transfers to the private sector to support business that otherwise have gone bankrupt. Both the US CARES program $25 million[8] and ADB CPRO $14 million place funds directly in the hands of the population and generate an increase in aggregate demand for goods and services. In sum $70 million of funds will have been pumped into the FSM economy during FY20-FY21 amounting to 19 percent of GDP.

Mitigation programs have helped reduce the impact on GDP but not as much as may have been generally anticipated. Our estimates indicate that the impact of these programs has reduced the decline in GDP from the earlier estimate of 6.7 percent to 5.0 percent over the two-year period. Given that the measured impact of the various mitigation efforts does not directly affect production levels in the worst affected sectors of transport and tourism, the effect of the various programs on measured GDP is not as great as may be anticipated. An example may help to explain: if a hotel operator is given funds through the mitigation program and those funds are used to pay employees and offset utility, tax, social security, and other costs, the measured value-added (contribution to GDP) of the enterprise is not affected at all. The added stimulus thus adds only to aggregate demand and, indirectly, to some additional output in the economy when spent. This is not a critique of the programs as designed and implemented. In fact, programs to target the protection of disposable income of affected households would be preferable to programs designed to purely protect measured GDP. Similarly, programs to address national health system vulnerabilities are meritorious despite their import-intensive character.

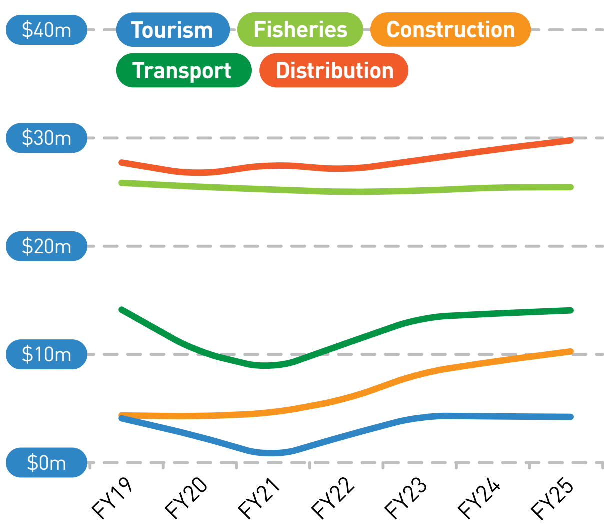
[8] Estimated from actual employment loss in FY20 and projections for FY21.

Major Industries Affected by the Pandemic

The hotel, restaurant and transport sectors are the worst hit by the pandemic. Figure 11 shows the major industries which are affected by the pandemic. Fisheries is projected to remain stable in FY20 reflecting offsetting movement in fish catch at Caroline Fisheries Corporation and Diving Seagull. From FY21 onwards the industry is projected to remain stable with no anticipated change in the size of the domestic resident fleet. The non-resident domestically flagged sector has been increasing in recent years, but due to its low economic impact and overseas center of economic interest the production of that fleet is not counted in GDP. The hotel and restaurant sectors are projected to fall by 40 percent in FY20 and then a further 73 percent in FY21, reflecting the absence of tourists and minimal interstate visitors. Recovery is projected to commence in FY22 with full recovery achieved in FY23. Similarly, the transport sector is projected to decline by 28 percent in FY20 and a further 14 percent in FY21 with the impact predominantly in the transport component. Given the total output in the transport and communications

Figure 11 Major industries affected by the pandemic (value added constant prices)

Transport and tourism are the worst affected by the pandemic



sector, the impact on GDP loss is greater in magnitude than the impact of the hotels and restaurants sector.

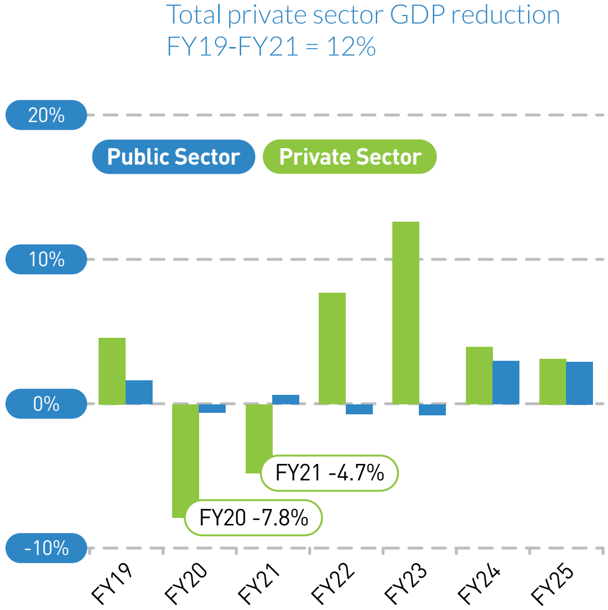
Construction activity is projected to pick up post-pandemic reflecting implementation of donor projects put (effectively) on hold during the pandemic. Construction activity is projected to remain largely unchanged in FY20 and FY21. Despite the demand for infrastructure from a backlog of donor funded projects, travel restrictions and shortages of both supplies and engineers and other skilled personnel have limited the capacity of the industry to grow from its very low level. In FY23-FY25 the projections indicate something of a boom in construction work as pandemic constraints become eased and donor projects including the Compact infrastructure grant are able to proceed. Finally, the large wholesale/retail sector declines by 4 percent in FY20, despite a booming retail sector, reflecting weak demand for building materials and a large reduction in demand for aviation gas from the FSM's sole fuel distributor, PetroCorp. In subsequent years the projections suggest continuing growth in the sector as the economy picks up post-pandemic.

Impact on Private and Public Sectors

Private sector is projected to contract by 14 percent during FY20 and FY21. Figure 12 indicates the impact of the pandemic on the private and public sectors. The public sector is projected to decline only incrementally in FY20 and then grow slightly in FY21 with some contraction through FY23. The majority of the COVID-19 impact, however, is felt on the private sector. In FY20 a large reduction of 9 percent is indicated, and in FY21 a further reduction of 4 percent is projected. Overall a very sizeable loss in cumulative value-added of 12 percent is projected for the private sector.. This is 5 percent less than the 17 percent loss projected without the mitigation programs.

FSM Tourism Sector Mitigation Relief Fund and ADB CPRO have been designed to specifically support the private sector. While the overall

Figure 12 Projected private and public sector growth



impact of the pandemic on the economy may appear "conservative," when the structure of the economy is taken into account it is clear that the impact is highly uneven. During the crisis, the public sector remains largely unaffected, while the impact on the private sector is severe. This uneven characteristic can be taken further as, for example, individual enterprises in the hotel and restaurant sector may see output decline to zero during the COVID-19 pandemic. This illustrates the need for careful targeting that has been undertaken by the FSM national government in the design of the TSMRF and ADB CPRO. Both programs have been designed to directly support the private sector as well as affected households.

Impact at the State Level

Impact of the pandemic varies significantly by state. Figure 13 describes the impact at the state level. GDP is normalized with FY19 being equal to 100[9]. As with the uneven economic impact of the COVID-19 pandemic between

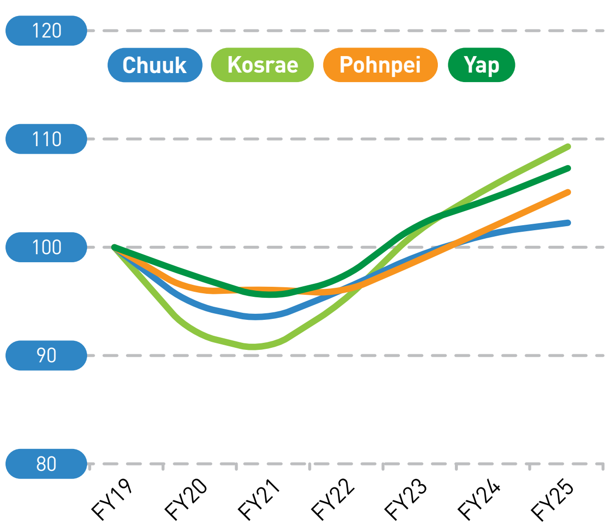
[9] Given the large influence of the Yap state purse seine operator Diving Seagull data relating to DSG has been removed from the index.

The majority of the COVID-19 impact is felt on the private sector in FY20-21… overall a loss in cumulative value-added of 12 percent is projected for the private sector.

private and public sectors the impact at the state level is also uneven. In Pohnpei, the host of the national government, state GDP declines by 6.6 percent over the two-year period. In Chuuk and Yap, the decline is 3.9 percent and 5.0 percent, respectively, slightly less than the FSM-wide average of 5.0 percent. In Kosrae the decline is the largest, at 9.4 percent. The differing impact of the pandemic on the four state economies naturally reflects the assumptions and structure of the respective economies. In particular, the importance of tourism and private sector transport activities drive the result. Figure 13 indicates that Kosrae which is projected to fare the worst on the downswing is projected to be the state the most rapid recovery and growth through FY25. This reflects not only recovery but also the impact of greater infrastructure and project spending assumed after the pandemic has passed.

Figure 13 Economic prospects at the state level: FY19=100

Impact of COVID-19 varies signficantly by state



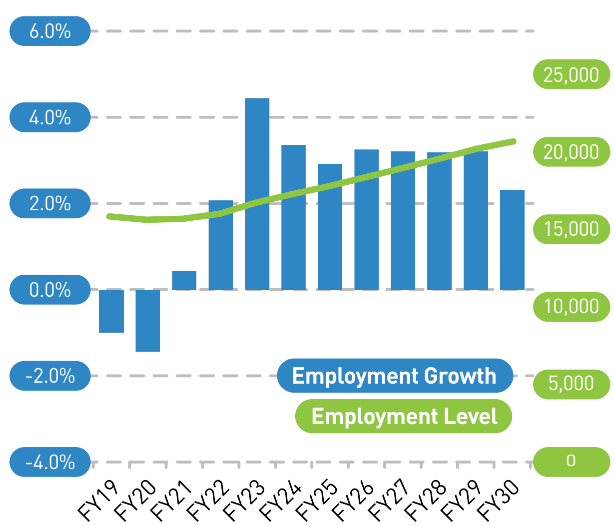
Employment Impact

Original projections of job loss indicated a potential large increase in unemployment. The impact of COVID-19 on employment is shown in Figure 14 indicating both level of jobs and annual changes. The original projections of the impact of the pandemic in May 2020 projected a job loss of 1,800 jobs over FY20 and FY21 and represented a reduction of 11 percent of the FSM-wide employment on FY19 levels. This projection was based on two important factors: (i) a constant labor-output ratio or relationship between output and employment and (ii) the May 2020 exercise did not incorporate the impact of the various mitigation programs on the economy.

Preliminary estimates for FY20 indicates a job loss of just 225 people due to the pandemic. Since the time of the earlier exercise preliminary employment estimates for FY20 has now

Figure 14 Employment level and growth: actual in FY20 and projected thereafter

Employment impact is considerably less than originally projected



become available, based on data for larger employers. The employment figures for FY20 shown in Figure 14 indicate an actual job loss of 225 people with a small improvement projected for FY21. However, in the COVID-19 impacted sectors of tourism and transport a job loss of 278 for FY20 was observed, representing an average for the year including the initial two quarters before the crisis hit. A total job loss reflecting a full year of impact of the pandemic of 504 jobs for the affected sectors has been estimated. This implies offsetting job creation in other sectors close to 350 jobs mainly in retail and government reflecting the impact of the mitigation efforts.

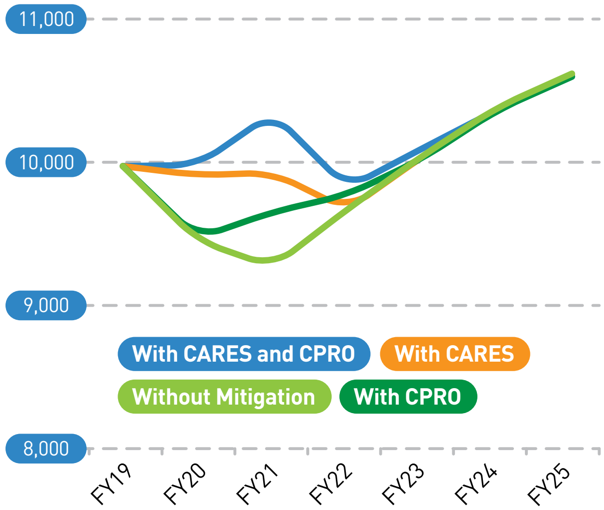
The impact of the pandemic on employment has thus fortunately been considerably less than originally feared although it remains significant. The earlier assumption of a fixed relation between output and employment clearly overstated the case. Not only did the tourism sector mitigation relief fund help maintain the salaries of affected people but impacted businesses would have been likely to institute a reduction in hours before terminating jobs thus reducing the impact on employment. In the economic modeling framework, the assumed dependence of jobs on production or output has been used in reverse in recent GDP estimation, i.e. that output can be proxied by changes in employment. This assumption, which was always second-best to actual data, is no longer tenable and has serious implications for continuation of national accounts series which is addressed in the following policy section.

Household Incomes.

Household incomes rose during the pandemic but are projected to fall in FY22 once the mitigation programs are complete. The impact of the various mitigation programs: the US CARES Act and ADB CPRO have a very significant impact in supporting household incomes as shown in Figure 15. Without either of the two programs this study indicates household incomes would have fallen by 6.3 percent. The US CARES Act came into force not long after the start of the pandemic supporting household incomes in both FY20 and FY21. Funds from the ADB CPRO did not get released until FY21 and are projected to continue supporting household incomes into FY22. Combining both mitigation programs household incomes were projected to have risen by 0.1 percent in FY20 and to have risen by 3.1 percent in FY21, thus well above their FY19 levels. Looking forward, however, the main issue of policy concern will be a reduction in incomes in FY22, estimated to be 4.7 percent, that will result once the programs are withdrawn and before the economy has fully recovered.

Figure 15 Real household incomes, FY04 prices

Mitigation programs have signficant impact on real household incomes

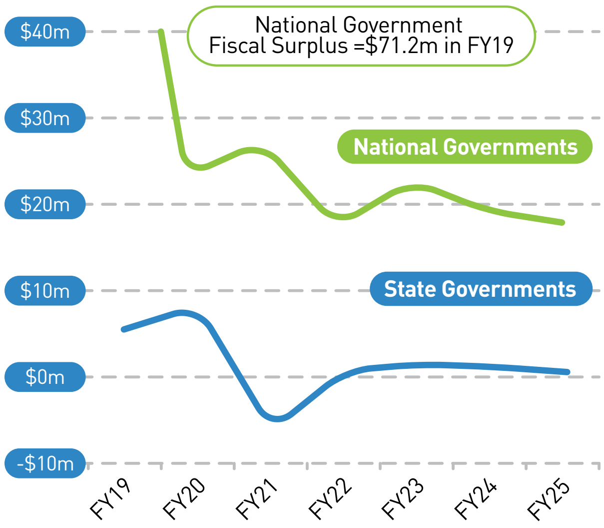


Fiscal Impact

State governments are projected to maintain fiscal balance during the COVID-19 pandemic. The fiscal outturn is projected in Figure 16 and is decomposed into the fiscal position of the national and state governments. The state governments are assumed to operate on a balanced budget rule and adjust to the annual fiscal drag implicit in the amended Compact and the COVID-19 cyclical downturn to attain fiscal balance. That said, there may be short-term deviations such as a surplus in FY20 and deficit

Figure 16 State and National Government Fiscal Deficit

Natonal government continues to run large fiscal surpluses during COVID-19



in FY21 where the fiscal outturn is worse than budgeted and there is a lag in response.

Impact of lost tax revenues in state governments is projected to be small. During the FY20-FY21 period the four states suffered from reduced tax revenues which fall by 1 percent for Chuuk, 9 percent for Kosrae, 2 percent for Pohnpei, and 2 percent for Yap. However, in terms of total state government revenues and reflecting the dominance of Compact flows, the proportional reduction of revenues is more moderate: 0.3 percent for Chuuk, 1.1 percent for Kosrae, 0.8 percent for Pohnpei, and 0.3 percent for Yap. The overall impact of lost tax revenue due to the COVID-19 pandemic is projected to be small, and less than $0.5 million or a 1.9 percent decline across all states.

Sovereign rents are projected to return to normal levels during the pandemic and remain stable through FY25. The national government has achieved large fiscal surpluses in recent years, averaging 16 percent of GDP from FY15 through FY19. In FY19 an unusual level of corporate tax receipts from the FSM domicile for major Japanese corporations resulted in a large fiscal surplus. For FY20, with revenues returning to normal levels in the FSM domicile industry and stable in nominal terms for sovereign rent receipts from fishing royalties, and minor impact of the COVID-19 pandemic on domestic taxes, the fiscal position is projected to remain stable.

The overall impact of COVID-19 on the fiscal position of the national government is projected to be minor. On the expense side the major additional funding need of the national government has been financing of the tourism sector mitigation relief fund. However, drawdown of funds has been limited due to the number of firms enrolled. The large discretionary source of expenditures is legislative projects which rose to a record $28 million in FY19. In the current study a level of $14 million in legislative projects has been projected through FY25. In FY20 a fiscal surplus of $24 million is projected and rises to $27 million in FY21 with accumulated reserves of unspent grants. As unspent funds are drawn down in FY22 a reduced fiscal surplus is projected but stabilized with an average of $19 million through FY25.

Conclusion

Strong government action coupled with generous support from the donor community to secure the FSM's financial needs has left the economy well positioned for recovery. At the onset of the COVID-19 pandemic, when matters were highly uncertain, the need for financing was unclear. As matters transpired the FSM was spared any outbreak of COVID-19, and sufficient resources for health needs were funded through donor sources. The US CARES Act supported the unemployed with generous funding and the ADB CPRO provided resources for low-income households and the vulnerable in the population. The FSM's own stimulus program supported the small tourism industry. The combination of these factors has ensured the financial stability and security of the FSM economy. With implementation of the vaccination program, albeit at a slower than desired rate, the FSM economy is well positioned for recovery.

Economic and Fiscal Policies to Support the Recovery and Economic Growth Beyond

The earlier COVID-19 impact *Economic Assessment* paper of May 2020 was written before a well-articulated response program had been fully developed and funded. The earlier paper thus outlined a series of potential options the FSM and donors might have wished to consider in the crafting of a response program. In the wake of the COVID-19 pandemic the focus shifts to the need for the FSM to develop a set of policies and, perhaps, programs that will assist the recovery and development of the nation through the end of the FY23 and beyond.

Statistical Issues

Department of Finance and Administration terminated data sharing with Statistics Office. A longstanding issue since FY16 and one that is now of major concern and raised in the previous section, is the implications arising from a lack of sharing of information between the Department of Finance and Administration (DOFA) and the Statistics Office of the Department of Resources and Development (R&D). Data sharing between the two entities had taken place since the compilation of the current GDP series began at the start of the 2000s under an MOU ensuring the confidentiality of the information shared. The confidentiality of propriety information collected by the Statistics Office is further protected under the Statistics and Census Act PL 5-77 of 1988.

The need for compliance with OECD and Global Forum exchange of tax information between external jurisdictions was given as the reason for termination of inter-departmental data sharing. During the preparation of the FY16 national accounts, DOFA officials indicated that it would no longer be in a position to provide the information previously supplied, a copy of the Business Gross Receipts Tax (BGRT) rolls, to the Statistics Office citing OECD and Global Forum requirements relating to the exchange of information between jurisdictions. This effectively cut off a major source of information for the compilation of private sector GDP and GDP by industry. As an interim response Social Security information collected annually was used as a proxy for the missing BGRT data. In essence the assumption was made that employee counts were an acceptable proxy for changes in private sector output and value-added. This was a tenable assumption given the slow rate of growth and lack of structural change in the FSM economy. As a result, GDP estimates were prepared for FY16-FY19, but these were deemed "preliminary" and published without the industry tables. It was envisaged that the estimates would be revised, and the full set of tables published once the BGRT data access issue was resolved.

Use of Social Security data as a proxy for tax information is no longer tenable and continuation of the GDP series by private sector and industry is not fit for purpose. However, as the recent employment data for FY20 and the reduction in output due to the COVID-19 impact indicates the use of social security employment data as a proxy for changes in private sector output and value-added is no longer a tenable workaround. The fixed relationship between output and employment—always a second-best proxy—has completely broken down. In FY20 output fell but employment was maintained as businesses held onto many of their staff, likely on reduced hours. Under these circumstances the GSUSA can no longer estimate the private sector, industry and GDP series, as the methodology used is no longer fit for purpose. GSUSA will, however, continue to maintain other national accounts series that it produces in collaboration with FSM

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

Statistics Office as it has in the past with a view to restarting the series once the "missing" data becomes available to the Statistics office.

Lack of provision of GDP series will impact country economic surveillance. Clearly, this is at least a temporary setback for the provision of key statistical series on which the performance and progress of the FSM economy is monitored. While this will be a setback for the ability of the FSM to monitor its own progress, it will also hinder country surveillance by the international donor community and the biannual Article IV consultations between the IMF and the FSM authorities. It is reported that in the recent biannual Article IV IMF mission, the FSM Department of Finance and Administration provided the mission with GDP by industry estimates. The Department has also indicated the FSM is working in consultation with IMF and PFTAC on its National Accounts technical assistance needs.

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

1. Confidentiality applies only to sensitive tax information. This is essentially limited to tax information that may disclose the identity of the taxpayer or commercial secrets. It is made clear that aggregated data can be exchanged.
2. Sensitive tax information can be exchanged with officials of other Government departments to the extent provided under an MOU entered into between the originating and the other department. This will include Statistics, but perhaps other departments, such as that agency responsible for anti-money laundering, serious crime, etc.

Technical Assistance is recommended to draft changes in law as needed and an MOU between DOFA and the Statistics Office. In order to rectify the current situation and regenerate the economic series and set the future on an assured path, it is recommended the FSM seriously considers adopting the new framework developed in the South Pacific. A request to the Pacific Financial Technical Assistance Center (PFTAC) an arm of the IMF, which has previously supported and advocated sharing of information within governments, would be a possible source. Not only would this enable the inclusion of the missing data into the time series but would also provide a launching pad for the further advancement of the FSM economic statistical series, adoption of national accounts software, quarterly reporting, rebasing and incorporation of new data that has gone on hold for several years.

Private Sector Issues

The Skipjack Fishery and the Domestic Fleet

The Parties to the Nauru Agreement and Vessel Day Scheme has proved highly beneficial to the FSM. Fishing in the region now effectively comes under the Parties to the Nauru Agreement (PNA)--a cartel of 9 Pacific Island states including PNG, which has led to a remarkable and sustained increase in member country revenues from the Vessel Day Scheme (VDS) and sale of vessel days. The PNA has led to a fivefold revenue increase for the FSM since the start of the amended Compact period. Daily fishing rates average close to $12,000 per vessel day and the FSM received $73 million of revenues or 18 percent of GDP in FY19. Each PNA member is accorded a Party Allowable Effort or PAE that is set in relation to the size of its fishery. For the FSM the PAE averaged 7,300 days between 2015-2018 and is reported to have increased in the last few years.

The FSM arrangement (FSMa) provides large discounts to promote development of the local fishing industry. The "domestic" purse seine fishing fleet comes under a regional arrangement amongst Pacific nations known as the FSM arrangement (FSMa), whereby the owners pay a reduced daily rate negotiated between the host nation and the respective operators. For fish caught in the FSM the rate paid is the negotiated rate, but for fish caught by FSMa vessels in another FSMa jurisdiction a $4,000 transfer fee is required. The FSMa was established to encourage the development of the local fishing industry. However, there is significant debate as to whether the domestically flagged vessels make substantially greater contribution to the economy than 3rd country fishing vessels operating without a discount.

Under the FSMa 28[10] vessels have been domestically flagged representing 70 percent of the FSM Party Allowable Effort. In the FSM's economic statistics, domestically flagged FSMa vessels are either treated as resident or non-resident. Resident operators have a center of economic and financial interest beyond simply establishing an office or "post office box" in the FSM. Domestic non-resident vessels are likely to have been registered in the FSM to capture economic rents from reduced domestic fishing day rates granted under the FSM arrangement. There are two companies considered as resident: Yap State Diving Seagull (DSG) and Pohnpei's Caroline Fisheries Corporation (CFC). DSG has two boats and CFC six. Both corporations have government ownership (partial or full). There are 20 vessels flagged in the FSM but not considered as resident. There are 3 major companies that operate 12 vessels, 4 vessels are Japanese owned and the remainder Chinese Taipei. There are a further 8 other vessels flagged in the FSM, 6 of which are registered in Kosrae, and the majority Chinese Taipei owned.

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

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

There is a need for a transparent evaluation of the FSMa so FSM policy makers can make informed and evidence-based decisions on the rationale for, and size of, the discounts. The above hypothetical estimates are provided to illustrate the magnitude of the possible loss to the FSM. This is a matter that requires careful evaluation of the benefits of domestic flagging of vessels under the FSMa, where the private owners make substantial gains, perhaps at the expense of the local economy and the national treasury. This issue has been in question for some time, but over which there is lack of transparency of the underlying economics of the arrangements. Only when there is full disclosure can FSM policy makers make informed and evidence-based decisions on whether the discounts provided are worth the

[10] See **Western Central Pacific Tuna Commission**: record of fishing vessels data base.

cost. PNG, for example, is reported to provide a discount or rebate to PNG-flagged vessels only upon presentation of proof of benefits derived from employment and purchases of goods and services in the local economy.

NORMA should consider a bonus scheme to incentivize staff to improve revenue performance. Based on the size of the domestically flagged purse seine fishing fleet operating under the FSM agreement, it may be deduced that approximately 70 percent of fishing revenues are derived from this source. Clearly, the incentive to increase revenues at the management and Board of level of NORMA from the sale of VDS days is weak when days can be sold upfront at low prices and guaranteed without risk. Many revenue authorities incentivize their staff to increase revenues through bonus schemes. The management and Board of NORMA would be more proactive to reduce days sold under the FSMa and increase earnings if a bonus scheme were introduced. While it is not suggested that a high risk, high-cost incentivized strategy should be introduced, a more proactive remuneration scheme would likely encourage better results.

FSM Domicile for Japanese Companies

FSM has benefited mightily from the creation of the FSM domicile for Major Japanese Corporations. In 2005 the FSM passed corporate tax legislation that enabled the creation of an overseas domicile which has primarily been targeted at Japanese Companies. The law provides for a corporate tax rate of 21 percent, and through differential tax rates, the FSM host environment provides an attractive domicile for Japanese captive insurance companies and other corporations. The benefit of these arrangements has been a steadily growing stream of revenues to the National government now averaging a relatively steady $10 million in recent years from captive insurance companies, and occasional capital gains -related tax revenues from major international companies. In FY14 there was an unusually large receipt of $28 million, reflecting a large declaration of capital gains by one company. In FY17 there was a further large receipt of $23 million by one corporation. In FY18 there was a receipt of $77 million from another Japanese organization and in early FY19 there was a receipt of $62 million. Although large payments can be expected periodically, FY18 and FY19 were exceptional.

> *FSM's efforts to respond to a severe threat resulted in the FSM now being deemed to be largely compliant with Global Forum and OECD requirements.*

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

> *The Global Forum rated Federated States of Micronesia (FSM) overall Largely Compliant with the international standard on transparency and exchange of information upon request. The FSM's legal and regulatory framework is generally in place to provide for effective transparency and exchange of information. The relevant rules also appear to be adequately implemented overall. However, this remains to be confirmed in practice. This can be attributed to the fact that the FSM does not*

have any EOI instrument providing for exchange of tax information with other jurisdictions despite its efforts to conclude one, and thus the FSM has never been asked to exchange information with foreign jurisdictions. In addition, legal requirements containing crucial rules concerning the availability of ownership and accounting information are recent and remain to be fully tested.

Earlier concerns of non-compliance have thus been largely addressed and the FSM has even stated that it intends to join the Global Forum as a member to maintain its good standing into the future.

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

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

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

Public Financial Issues

Tax Reform

FSM tax reform has been low on the agenda but warrants reconsideration as the nation pulls out of the COVID-19 pandemic and enters a new Compact era. In the mid-2000s the FSM embarked on a lengthy process of tax reforms, which after many years of donor support and hard work by officials of all five governments has not yet led to adoption. With a tax/GDP ratio of 13 percent, ignoring FSM-domicile corporate taxes (average FY17-FY19), FSM tax effort has been low, and a tax reform initiative presents an opportunity to adjust to future fiscal shocks and to create an efficient tax environment that supports private sector development. Two of the four FSM states (Chuuk and Kosrae) supported the tax reform initiative. Yap State, while expressing no objection to the reforms indicated that the proposal was unconstitutional with respect to Yap's state constitution, and thus declined to participate. There was some renewed recent interest from Pohnpei State, where a disproportionate benefit from tax reform would accrue, but this now appears to have waned. There is clearly little incentive for additional revenue effort at the national government due to booming sovereign rents and given that, under current arrangements, 70 percent of the domestic taxes accrue to the states. However, if the FSM wishes to improve revenue buoyancy, and efficiency to support development into the new Compact era, reconsideration of the tax reform and modernization effort should be high on the agenda.

The FSM President's recent announcement of the creation of a National Tax Reform Commission indicates a stated purpose "to find a means to improve citizens' livelihoods, expand and update the Nation's revenue base, and attain or implement the equitable sharing of revenue between the Nation's States of Yap, Chuuk, Pohnpei, and Kosrae." It will be important that the entire revenue regime—not just the outdated aspects of the tax regime—be studied. Similarly, it will be important that the focus on equitable sharing of revenue "between the Nation's states…" be interpreted to include sharing of revenue amongst the nation's five governments. The last time the FSM adopted a fundamental revenue-sharing policy outside of the original terms of the FSM Constitution, was prior to the outset of the original Compact economic assistance period that started in FY87. Given the massive changes to the revenue base since then and the impact on national and state shares of revenues, the President's Commission is timely if its scope is sufficiently broad.

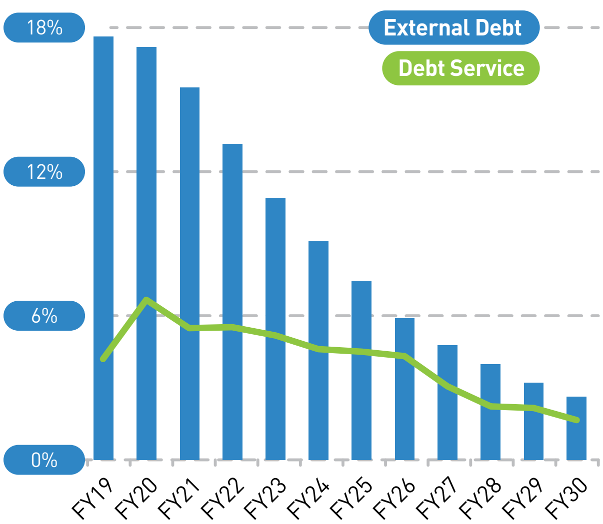
External Debt

FSM has an admirably low external debt profile. The FSM's external debt, at 15 percent of GDP and 11 percent net of offsetting assets (sinking fund), is one of the lowest in the region. Debt service of 5 percent of national government domestic revenues remains well within the capacity of the national government to service and does not present any threat of debt stress, see Figure 17. A recent review by the FSM public auditor revealed many weaknesses in the FSM's external debt management. As a result, a debt management bill has been drafted but has yet to be acted upon by the FSM Congress. Addressing debt management as part of improving Public Financial Management (PFM) sooner—while debt distress is not a concern—rather than later is advisable.

FSM has been accorded "grant only" status and is benefiting from large increases in external aid. While this analysis indicates that the FSM is not at risk of debt distress, the standard World Bank / IMF Debt Sustainability Analysis (DSA) places the FSM in an at-risk category. The DSA analysis assumes that large fiscal shortfalls projected post-FY23 would be financed through (hypothetical) concessionary external borrowing. However, the FSM does not have access to the assumed persistent borrowing from global capital markets or even from donors, especially to maintain operational expenditures. While the World Bank / IMF's assumptions may differ from what would actually transpire if the FSM experienced a severe post-FY23 fiscal shock, the consequence of the DSA is that the FSM has been accorded "grant only" status for access to resources. Under the current round of World Bank IDA 19 funding, the FSM is thus not eligible for loan finance, but does qualify for up to $25-$30 million of grants annually. In addition, with increased grant allocations averaging $15 million from the Asian Development Bank and other major donors, the FSM is currently benefiting from a large increase in grant-only external aid compared with historical levels.

Figure 17 External debt and debt service, % GDP and % general fund revenues

Under grant only status the FSM's external debt position is proejcted to improve



Structural Surplus and Contributions to the FSM Trust Fund

National Government runs large fiscal surpluses. The boom in national government revenues derived principally from fishing fees but also large periodic gains from corporate taxes from FSM-domiciled Japanese companies has led to the generation of large fiscal surpluses at the national government. In FY15 the national government ran a fiscal surplus of $35 million or 11 percent of GDP which had risen to $98 million or 28 percent of GDP in FY18 and fell to $71 million or 20 percent of GDP in FY19 (see Figure 8). Without any windfall gains from the FSM domicile the fiscal surplus is projected to have fallen to a still strong $24 million or 6 percent of GDP.

Large fiscal increase in revenues has enabled large increase in expense on goods and services and Congressional district public projects. While revenues have grown rapidly the increase in fiscal space afforded by the increase has also enabled a large increase in expenditures on use of goods and services and Congressional district projects. From an average of $19 million in FY2009-FY13, the use of goods and services rose to $48 million in FY19 some of which may be attributed to World Bank spending which is not segregated in the FSM's Financial Management Information System Chart of Account. Still, outlays on public projects have risen from an average of $3.3 million during the first 9 years of the amended Compact to $28 million in FY19. Taking these rapid increases into account a measure of the structural fiscal surplus at the national government can be estimated: rising from $5 million or 1.7 percent of GDP in FY11 to $70 million or 21 percent of GDP by FY19.

Analysis of the structural surplus indicates the national government has saved about two-thirds of the available funds: a significant achievement. An analysis of the total structural surplus generated since FY15 though FY19 yields a figure of close to $497 million. Of this $177 million was utilized for increases in expenditures on use of goods and services and Congressional district projects above the FY15 inflation adjusted level. Thus, the FSM national government spent 34 percent of the surplus and saved an estimated 66 percent mostly in the FSM Trust Fund.

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

Favorable outcome in Compact economic assistance renewal negotiations will challenge the FSM to adopt a State level driven process that allocates resources efficiently to development priorities. The boom in sovereign rents has enabled the FSM to save very considerable resources into the FSM Trust Fund. With two full years to run before the expiration of the economic assistance terms of the amended Compact the nation has built up a sizeable cushion on which it could rely should an unfavorable renegotiation materialize or possibly a delay in funding such as occurred to Palau in 2010 when agreement was reached with the US, but funding was not appropriated until 2018. The FSM has set aside these resources to support the nation in the event of a poor settlement post-FY23, and presumably to support the FSM in the event of climate change-related or other emergencies. However, if as has been assumed in the projections in this *Economic Assessment*, there is a favorable Compact renewal result, the FSM will be faced with a new challenge of how to use the nation's sovereign rent resources in a productive and efficient way for its future development. This may challenge the FSM to move away from a resource allocation process controlled at the national level to a proportionally more state level driven process to allocate recurrent revenue resources. As noted above, a sufficiently broad interpretation of the newly created National Tax Reform Commission may be a good vehicle to identify options for the nation's leadership to consider.

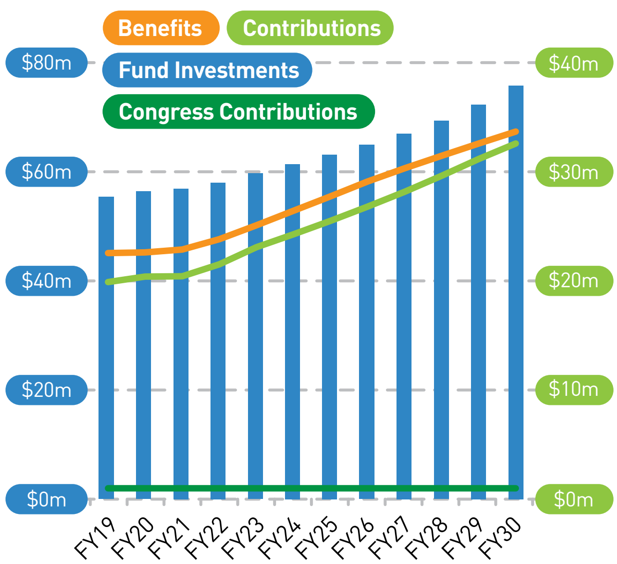
Social Security Sustainability

Financial outturn for SS turned out favorable in FY19. As of January 2017, an actuarial assessment of the FSM Social Security Fund indicated an unfunded liability of $286 million compared with assets of $51 million, a funded ratio of 18 percent. Contributions to the fund in FY19 were $19.9 million in comparison to $22.6 million in benefit payments, that is contributions covered 88 percent of benefit payments and Social Security required additional funding to fill the gap. Investment returns were large in FY19 at $8.3 million in comparison to a $3.1 million loss in FY18. The national government has been providing a $1 million annual appropriation to support the fund in recent years. Reflecting these finances fund investments rose by $7 million during FY19.

Long-run projections based on Compact renewal look favorable, but under an adverse scenario SS investments would decline. Long-run projections, see Figure 18, indicate benefits rising largely in tandem with contributions. Benefits, growing at 3.7 percent are derived from projections provided by Social Security, while contributions are projected in tandem with wage projections derived from the GSUSA's economic model (MTEF-mod) and grow at an annual rate of 4.6 percent. Investment returns are projected at 7.0 percent. The resulting outcome indicates

Figure 18 Social Security benefits, con tributions and fund investments

Current projections of the FSS Social Sectuirty System indicate the Fund remains sustinable



fund investments increasing by $14 million and that the Social Security system remains on a sustainable trajectory. However, the wage projection reflects a bullish Compact renewal scenario post-FY23. If Compact renewal turns out less favorable and there was no further provision of the Compact sector grants, wage growth is estimated to be reduced to 3.1 percent. In these circumstances fund investments would decline by $8 million to $42 million from the current $50 million. These simulations suggest the Social Security system should be carefully monitored. While the current position is favorable, if the economy fails to grow, the outcome will look less positive.

State Owned Enterprises

Telecom and ICT Reforms

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

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

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

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

The ICT environment created by FSM law and supported by the World Bank coupled with access to local telecom infrastructure has provided a cost competitive environment for new entrants. The envisaged connectivity to the home, operationalized by the OAE, coupled with a requirement that FSM Telecom must provide access to third parties to its cell tower network, lays the foundation for new entrants to enter the market. While the ICT law requires that new entrants provide services to all four states if they wish to operate in Pohnpei or Chuuk, the provision of low-cost infrastructure financed through World Bank grants, should, even in a small marketplace, provide a commercial environment attractive to foreign investors. As a result of the environment created by the World bank several new entrants to the market have been issued licenses. These include iBoom a small indigenous startup intending to provide services to Yap, Kacific a traditional geosynchronous satellite business providing services to underserved locations in the FSM in Kosrae, outer islands of Pohnpei and Chuuk, and finally Chuuk Public Utility Corporation, previously focused on power and water, but now planning to expand to include fiber in the islands of Chuuk Lagoon.

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

FSM PetroCorp and Coconut Products for Export

FSM PetroCorp is a welcome example of a persistently well-run SOE. The FSM PetroCorp was created in 2007 to take over the operations of the departing supplier, Mobil. The transfer proceeded well and PetroCorp was able to achieve an annual return on capital of 13 percent between FY10 and FY17 above the target of 10 percent. While FY18 was a poor year of financial performance, in FY19 performance improved and the company recorded a profit rate of 5.2 percent. As the level of retained earnings and the capital base has risen, profitability has fallen reflecting a largely static level of net income. The advent of the COVID-19 pandemic had significant impact on fuel sales which fell by 17 percent in FY20, reflecting a significant fall in aviation gas and marine fuel sales. PetroCorp has now opened diversified operations to Guam and Nauru and is a welcome case of a persistently well-run SOE.

PetroCorp has performed well; however, the Coconut venture is high risk and requires separation in the audit to monitor developments.

Diversification into copra processing is a high-risk venture. A Bill before Congress entitled the "Transformation Act" is intended to provide clarity on the mission of PetroCorp. The bill indicates the need to transform the business model from a successful fossil fuel importer to (i) a low-cost carbon free energy supplier and (ii) exporter of high value agriculture products. It is in the latter aspect that recent plans to expand horizontally through the opening of a coconut processing facility in Tonoas, Chuuk, that PetroCorp faces a risk to its capital base. While the project has been well designed and researched, investment costs are likely to escalate. Clearly this activity falls under the domain of venture capital, and it begs the question: should high risk projects be fully funded by public funds? For an industry that in the Pacific has been in decline for many years, with labor in short supply in similar low wage activities, and a declining raw material supply (due to aging coconut trees), the odds of success are not favorable. While technology has changed in the copra sector with potential for processing the whole product and production of virgin oil, the market is dominated by the Philippines, which provides 70 percent of world supply at low cost. Typically, government sponsored venture capital projects allocate investments where private sector investors have taken the lead and the public funds form a minority portion of the total investment.

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

To evaluate performance PetroCorp should provide information in the annual audit on the Coconut project on a disaggregated basis. In the interests of transparency and accountability, it is important that information about each PetroCorp project—or cost center as they already account for internally—be isolated in the financial statements as separate cost centers. Specifically, public audited information should allow for identification of cross-subsidization, and more generally to allow for careful monitoring and true costs of each discrete business activity.

Increasing the Rate of Investment and Long-term Planning

Infrastructure and the Economy

The large unused Compact infrastructure resources has now grown to nearly $250 million or 61 percent of GDP. Use of the Compact infrastructure grant was slow in implementation at the start of the amended Compact due to capacity constraints to implement the projects. However, by FY12 implementation issues had been overcome and expenditures exceeded that year's grant allocation of $22 million by $5 million. Improved performance was short-lived, and a series of issues plagued implementation with utilization falling to $5.3 million in FY19. Out of a total estimated allocation of $384 million since the start of the amended Compact, the FSM has only been able to use approximately $138 million, leaving approximately $246 million or 61 percent of GDP of unspent resources.

A series of issues and now COVID-19 have resulted in continuing delays and very low use of the Infrastructure grant. Project management issues, lack of clear priorities—or perhaps more specifically a mismatch between FSM-stated priorities and Compact language prioritizing health and education infrastructure, the JEMCO requirement to prepare an updated Infrastructure Development Plan (IDP), inability or unwillingness to provide professional engineers and contract management staff to the level required by JEMCO, and a perception within the FSM national government that requirements to proceed apace were either unclear or frequently changing over time resulted in further delays. By 2016 an Infrastructure Development Plan (IDP) was prepared to set priorities, but project management issues remained. After further delays, in June of 2017 a resolution between the U.S. and the FSM was reached to remove the suspension of the grant. Subsequently, the national project management unit (PMU) was partially reorganized, and each state established its own project management office (PMO). As part of the resolution—under pain of continued suspension—the U.S. Army Corps of Engineers was made available to respond to state PMO requests for technical assistance especially where the Corps can enhance project design and implementation through its BCOES process which entails a review to ensure each project is Biddable, Constructable, and Operable meeting Environmental and Sustainability standards. Unfortunately, within two years of finding a workable way forward, COVID-19 descended on the world and travel restrictions placed yet further delays on use of the infrastructure grant.

The delays in use of the infrastructure grant have been costly to the FSM economy in lost opportunities and in slower growth. After adjusting to the new conditions of the amended Compact, the economy performed favorably buoyed by growth in greater use of the infrastructure grant and FAA airport improvement projects. However, as construction demand dried up in the following three years FY12-FY14 the economy contracted by 8 percent. While much of the loss was due to the completion of large FAA airport improvement projects, a major part was due to the decline in the use of the infrastructure grant. This emphasized the importance to maintain the stimulative role in the use of the infrastructure grant. The large reservoir of unspent resources presents an opportunity to re-invigorate the FSM economy in the post COVID-19 recovery period during the remaining years of the amended Compact period and into the renewed Compact period thereafter. However, care should be taken to ensure that resources are spent relatively evenly, to prevent the boom-and-bust cycle that has afflicted the FSM.

Long-Term Planning

Use of FSM sovereign rents has followed an ad hoc process that included admirable levels of saving. In 2012, the FSM initiated an exercise to plan for transition to the post amended Compact era after FY23, known as the 2023 Action Plan. The backdrop at that time was that the post FY23 future was highly uncertain and that the Compact Trust Fund by itself would be unable to provide sufficient resources to support the on-going level of government operations. The Plan, while focusing on the post-2023 era, also addressed the use of the emerging national government structural fiscal surplus. However, since 2015, and during the COVID-19 era the 2023 planning effort, for obvious reasons, has not been active on the policy agenda. Rather, in the absence of a formalized plan the FSM Congress has saved about two-thirds of the resources—mainly to the FSM Trust Fund—and the remainder has been allocated to Congressional District projects and increased non-recurrent expenditures. While the additional spending might have been more efficiently and effectively utilized, the contributions to the FSM Trust Fund resulted in the Fund growing to $350 million by mid-FY21, a remarkable achievement.

Put simply, the FSM's fiscal situation begs for a profound and long-term restructuring of national and state fiscal operations, a task that has been understandably difficult to even discuss—much less achieve—in the presence of post-FY23 uncertainty.

The 2023 Action Plan, or something of similar scope, needs to be revisited as the nation emerges from the COVID-19 pandemic. Clearly, there is a need for a rational approach to economic management and allocation of significant sovereign resources. The former 2023 Plan established a useful framework for resource allocation and a renewed focus on private sector development and selective policy reforms. As the FSM recovers from COVID-19 and the post-FY23 amended Compact future becomes clearer, the government would be well-advised to revisit the former 2023 Plan, if not the precise content, to ensure the best use of readily available funds to address the FSM's future needs. Not only the annual sovereign rent stream but also earnings from the FSM Trust Fund can be switched to development needs in the states as the current policy of saving surplus funds to the Trust Fund to avoid a post-FY23 fiscal shock may no longer be needed. Put simply, the FSM's fiscal situation begs for a profound and long-term restructuring of national and state fiscal operations, a task that has been understandably difficult to even discuss—much less achieve—in the presence of post-FY23 uncertainty. Repeating from above, a sufficiently broad interpretation of the newly created National Tax Reform Commission may be a good vehicle to identify options for the nation's leadership to consider.

Conclusion

While the impact of the COVID-19 pandemic turned out to be less adverse than originally feared, the nation now needs to refocus its policy priorities for a more prosperous period. The outturn for FY20 and that projected for FY21 and beyond has turned out more favorable than anticipated. The FSM government can be credited with working proactively with willing donors to substantially mitigate the potential for far greater negative impacts on the economy as a whole and on affected businesses and individuals. The initial GSUSA impact study[11] was conducted shortly after the initial phase of COVID-19 was prepared before donor assistance packages had been mobilized. The favorable and generous level of donor support alleviated the immediate need for any significant fiscal adjustment at the state level. The strong fiscal position of the national government meant it could absorb financing of the Economic Stimulus Package with little need for offsetting adjustment. Indeed, the level of household incomes has risen during the period. However, as the nation emerges from the COVID-19 pandemic, at least four largely favorable opportunities present themselves to the leadership as they plan and make policies to support stronger growth in the future.

- The economic assistance terms under the amended Compact are expiring, while virtually all signals point toward a favorable negotiation of renewed terms.
- There remains a large amount of unutilized resources left over from the infrastructure grant that afford an opportunity for growth and the provision of growth-supporting infrastructure.
- "Grant only" status and high levels of grant assistance from the World Bank and ADB present significant, ongoing opportunities.
- Reduced need for accumulation of sovereign resources in the FSM Trust Fund, presents the opportunity to utilize the annual structural surplus of funds for development. However, this will require a new accord between the national and state governments of the scale and scope that has not been addressed since the outset of the original Compact in FY87.

[11] See ***Assessing the Impact of COVID-19 on the FSM Economy**, Graduate School USA, May 2020.*

About EconMAP

The Economic Monitoring and Analysis Program (EconMAP) provides professional expertise to support statistical development and economic analysis in the three Freely Associated States (FAS) of the Republic of the Marshall Islands (RMI), the Federated States of Micronesia (FSM) and the Republic of Palau (ROP). Annual program outputs for each FAS include the development of economic statistics, the publication of Economic Reviews, and the delivery of economic presentations. Economic issue papers, technical and policy notes are also published occasionally.

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