

**PROPOSAL BY THE GOVERNMENT OF THE FEDERATED STATES OF
MICRONESIA FOR FUTURE ECONOMIC ASSISTANCE BY THE UNITED
STATES UNDER THE COMPACT OF FREE ASSOCIATION**

As the FSM completed its Planning Framework 1999-2002, on a parallel track, this proposal for future United States economic assistance has been formulated and is herewith submitted at the renewed Compact negotiations.

In its concept paper, tabled at the Honolulu meeting in November, the FSM made a number of points:

THE COMPACT AND THE COMMITMENT OF THE UNITED STATES

The U.S. is committed through the Compact to assist the FSM in moving toward economic self-sufficiency. This is an international agreement, made effective at the time of termination of the former U.S. responsibility as U.N. Trustee over the Trust Territory of the Pacific Islands. The Compact memorializes that the U.S. interests in the stability and progress of the FSM, which are part and parcel of its comprehensive security interests in the region, including for strategic denial, did not terminate along with the Trusteeship.

Compact-related documents also set forth other goals for Compact assistance. The House Report on the implementing legislation (U.S. Public Law 99-239) states that U.S. assistance will "...ensure that minimum needs will be satisfied and that economic stability can be preserved. These, in effect, were the floor or "safety net" assurances that the Compact offered. As history has shown, the initial 15 years of funding fulfilled those purposes. Minimum needs were satisfied, stability was maintained.

Beyond those goals, however, was the pre-eminent objective of assisting the Freely Associated States toward economic self-sufficiency. The Preamble of the Compact eloquently affirms "...the interest of the United States Government in promoting economic advancement and self-sufficiency of the peoples of the Trust Territory of the Pacific."

Sections 211 and 454 of the Compact made similar commitments. The latter states:

"Notwithstanding any other provision of this Compact, the Government of the United States reaffirms its continuing interest in promoting the long-term economic advancement and self-sufficiency of the peoples of the Marshall Islands and the Federated States of Micronesia."

The experience of the past 12 years shows that there has been long-term economic advancement in FSM, even though self-sufficiency -- more usually termed "self-reliance" has not been achieved. While greater advancement would have been welcome, the results are consistent with original expectations. U.S. Assistant Secretary of State, Stanley O. Roth, testifying before Congress on

October 1, 1998, stated in part: "[T]he reality is that there has been some progress I certainly saw significant signs of economic development but they are not ready to go it alone [I]f the Congress and the Administration were to cut off funding today or when we renegotiate, then in fact I think we would have a very hard time in these entities [T]here would be a question as to whether we were being consistent with our historical relationship, indeed, our special relationship with these entities."

The U.S. commitment to help bring the FSM to that level is matched by the expressed national commitment of FSM leaders and people to the same goal. In an inter-dependent world self-sufficiency/self-reliance does not mean full economic autonomy. It does, however, mean the Ability, for the most part, to fund essential government services on a sustained basis from within the FSM's own resources, something that is not possible now.

THE IMPACT OF COMPACT ASSISTANCE

As noted, much has been accomplished over the past dozen years as a result of the economic resources provided by the United State through the Compact. But the impact of those resources has been blunted in some respects by the Compact mechanisms:

- Compact funding is complicated, imposes arbitrary spending targets and is based on five-year planning, a concept drawn from socialist countries that long since has been discredited. Moreover, levels were based on unrealistic estimated growth rates.
- Funding step-downs every five years have caused economic shocks, especially felt in 1996. In retrospect, a single level of payment over the 15 years would have been preferable.
- Termination of assured funding in 2001 effectively has discouraged new investment, both foreign and domestic.

The FSM is anxious, as we believe the U.S. should be, that new economic assistance agreements avoid these pitfalls.

REQUIREMENTS OF RENEWED U.S. ECONOMIC ASSISTANCE

The FSM believes that the keys to its preferred future are two:

First and fundamentally, to maintain long-term stability and security. As we have seen, this is a key national interest for the United States, stated in the Compact and related documents. This objective is essential to the continuing partnership between the United States and the FSM.

Second, to attain a state of self-reliance at which point our Nation will no longer require annual budgetary grants from the United States to finance essential government services.

As a result, this economic proposal to the United States is based on the following principles:

Supporting the explicit development objectives of the FSM. They are: maintaining stability and security, improving private sector-led economic growth, enhancing social services, ensuring environmental sustainability, and achieving ultimate self reliance.

- Macroeconomic realities. It may be thought of as a "top down" approach. It proceeds from a realistic assessment of the level of resources that will be required in the future to ensure continued political and social stability and to meet the minimum needs of the Micronesian people.
- Avoidance of lists of projects that represent an aggregate of requirements from specific areas such as health, education, fisheries, etc. Such a "bottom up" approach would obscure the larger economic realities that must drive these discussions.
- Increasing FSM self-reliance over the period.

An "exit strategy" that assures the United States that after a finite period of time, its continued annual budgetary help will no longer be needed.

The proposal has three mutually -supportive components:

First, for a limited period of time the continuation of the Compact program of economic grants; and

Second, continuation of Federal Programs to the extent that they support the FSM's economic and social development objectives; and

Third, the creation of a Trust Fund that in time would permit the U.S. to terminate its grants without fear of damaging the FSM's stability and security.

In the following sections we examine each component:

COMPACT ECONOMIC GRANTS

U.S. Federal grants under the Compact have been the single most important economic engine in bringing FSM to the level of development it enjoys today. They have facilitated a level of economic growth that is one of the highest among Pacific island states.

Such grants must be continued for an additional, limited period of time to support a smooth transition from the present FSM dependency on budgetary assistance to self-reliance.

These grants should be in the form of annual, straight-line payments to FSM absent arbitrary step-downs, to avoid repeating the past experience which created economic shocks and discouraged investment.

The grants would assist FSM in consolidating its reforms and thus lead the way into the next critical phase, that of economic restructuring. They would foster the FSM's private sector-led economic development strategy. The grants would also help fund the FSM's social sector strategies, with emphasis on health, education and infrastructure.

The level of U.S. grant support should be one that approximates the current level, which is \$84 million per year. For the near future, this level would fulfill two basic requirements for the FSM:

First, together with FSM's own revenues, it would ensure a level of government services sufficient to meet the basic human needs of the population. Thus U.S. grant funds at the proposed level would be a guarantee of meeting minimum needs and insuring future political and social stability in the country.

Second, beyond basic needs, this level of U.S. grant funding would permit FSM government investment in infrastructure required for further economic growth and progress.

This dollar number represents a "straight-lining" continuation of the amounts FSM has received in grants through the Compact during the third "step-down." It should be noted that this amount is significantly less in real terms than the FSM received from the U.S. in 1986 at the outset of the Compact. Because of the "step-downs" the annual grants received since 1996 have been the smallest under the Compact. The Nation has experienced economic "belt-tightening" that the second step-down imposed on FSM and its negative effects on economic growth.

The FSM has reduced government costs significantly as a result of the reduction in U.S. grant amounts, and it does not intend to loosen that belt. Thus the figure of \$84 million annually represents a minimum number that has been validated and recommended by the economic advisory team, the EMPAT, as well as by the FSM's own economists.

FEDERAL PROGRAMS

The second leg of the FSM's concept of future U.S. economic assistance is Federal Programs. The single audit reports on Federal Programs indicate that

they have contributed about 15% to the revenues accruing to the FSM and its citizens from the United States over the past 12 years. The FSM has always recognized the importance of Federal Programs to its progress and development. Doubtless, they will have important roles to play in the future. Therefore, the FSM will need access to existing Federal Programs and/or their successors, together with Federal Programs yet to emerge, to the extent that they support the FSM's social and development objectives.

THE TRUST FUND

Although FSM clearly will achieve significant economic growth at the grant levels proposed, such levels do not encompass an "exit strategy" from all further U.S. budgetary support – an objective in the interests of both parties. In effect, there is no guarantee that after 20, 30, 40 years that FSM would not still be reliant on a level – albeit a smaller level – of U.S. budgetary support. A true exit strategy requires additional contributions by the United States over a period of years to a new mechanism herewith proposed: The Trust Fund.

The purpose of the Trust Fund is after a finite period of time to generate sufficient income to replace the U.S. annual transfers. Trust fund revenue generations would become the principal source of funding for FSM essential government services. Precedents for this use of a Trust Fund can be found elsewhere in the Pacific.

The idea behind the Trust Fund is to have a financial corpus that yields the inflation-adjusted equivalent of whatever amount is required per year at the time full funding is achieved, to pay in perpetuity for the normal operating costs of government plus a limited amount of capital investment. This would permit the United States to cease all financial grants for the same purposes, at that time.

Clearly there are several ways in which a Trust Fund of the required size might be financed. It could be done with a single lump sum or spread out over half a century. The FSM proposes, as a practical method of creating the Trust Fund, that the U.S. contribute \$20 million per year (inflation-adjusted) for a period of years until the Trust Fund has grown to the point where it can generate sufficient revenues to replace the annual U.S. grant.

Our estimate is that to reach that point will require in the range of 20 years. This estimate is based on the following assumptions:

- An annual growth of GDP in the FSM of 2.5%
- A rate of return on the Trust Fund of 7.2% annually.

Here is how we see the process working:

The United States would continue to make contributions to the FSM in the year 2002 and beyond at the level stipulated in Section 231 of the Compact, should the conditions stipulated in Section 231 pertain.

During the years of buildup of the Trust Fund, the amount the FSM would receive annually from the U.S. would be \$84 million, indexed for inflation. Those grants would help the FSM to cover essential expenses.

An additional amount of \$20 million, inflation-indexed, would be contributed annually by the U.S. to the Trust Fund during the buildup years.

An amount would be transferred by the FSM each year to the Trust Fund equal to the growth experienced during the preceding year, if any, in FSM domestic revenues, along with any funds contributed to the Fund by other donors.

Revenues generated by the Trust Fund would be rolled back into the Fund corpus, and could not be withdrawn prior to maturity.

Maturity would be deemed achieved, and drawdown of Trust Fund-generated revenues would commence only after a sufficient corpus exists to generate annually an income of \$84 million less the difference between FSM domestic revenues at commencement of buildup and at time of maturity. The Fund corpus itself would remain inviolate permanently.

The creation of a Trust Fund for FSM and U.S. participation obviously involves a number of collateral matters, including the legal structure of the Fund, its management and decision-making, the types of valid investments, and other issues. Once both sides adopt in principle the strategy and mechanisms involved in the Fund concept, those details can be agreed upon in succeeding discussions.

Xxx

Breakdown of \$84,000,000:

Health	\$17,000,000
Education	\$25,000,000
Infrastructure	\$25,000,000
Governance	\$ 9,000,000
Private Sector	\$ 3,000,000
Transportation	\$ 3,000,000
Environment	\$ 2,000,000

Breakdown of \$61,000,000: US Gov't

Health	\$15,000,000
Education	\$23,000,000
Infrastructure	\$10,000,000
Capacity Building	\$ 4,000,000
Private Sector	\$ 2,000,000
Environment	\$ 2,000,000
Perform. Incentive	\$ 4,000,000