STATEMENT
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BEFORE THE
HOUSE COMMITTEE ON NATURAL RESOURCES
SUBCOMMITTEE ON INSULAR AFFAIRS

REGARDING
THE IMPLEMENTATION OF THE COMPACT OF FREE ASSOCIATION
WITH THE
FEDERATED STATES OF MICRONESIA

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Madam Chair and members of the Subcommittee on Insular Affairs, I am pleased to be here today to discuss the implementation of the amended Compact of Free Association with the Federated States of Micronesia (FSM).

In 2003, the United States Government approved the amended Compact with the FSM, providing a total of $2.3 billion in assistance for the years 2004 through 2023. The amended Compact's 20 years of grant assistance are intended to assist the FSM government in promoting FSM economic advancement and budgetary self-reliance. Under the amended Compact, Interior grant funding decreases annually, paired with increasing contributions to a trust fund established for the FSM; earnings from the trust fund are intended to provide a source of revenue for the government of the FSM when the grants expire at the end of 2023. In addition, annual grant funding is partially adjusted for inflation. The amended Compact requires the FSM to target Interior funding in six development sectors--education, health, the environment, public sector capacity building, private sector development, and infrastructure, with priority given to education and health. The amended Compact also provides for a Supplemental Education Grant, which is funded through the annual appropriations process and takes the place of certain domestic grants once offered through the Department of Education, the Department of Health and Human Services and the Department of Labor.

The Office of Insular Affairs is responsible for administering and monitoring all of these grants. The amended Compact's subsidiary fiscal procedures agreement requires the FSM government to monitor the day-to-day operations of sector grants and activities, submit periodic performance reports and financial statements, and ensure annual financial and compliance audits. In addition, the Compact and fiscal procedures agreement require the U.S.-FSM Joint Economic Management Committee (JEMCO) to (1) meet at least once annually to evaluate the progress of the FSM in achieving the objectives specified in the FSM development plans; (2) approve grant allocations; (3) review required annual reports; (4) identify problems; and (5) recommend ways to increase the effectiveness of

Compact grant assistance. The Compact also requires the U.S. representatives to the JEMCO to consult with the Secretary of Education on the objectives, use, and monitoring of U.S. financial and technical assistance made available for educational purposes. The FSM is also required to conduct annual audits within the meaning of the Single Audit Act for an independent review of its financial position.

The FSM and U.S. are currently in the fifth year of the twenty-year period of financial assistance under the amended Compact. Despite the hard work and good intentions of many, we are not satisfied with the results and outcomes that we have seen. However, we remain firm in our belief that with increased commitment by our partners in the FSM that the Compact will ultimately be successful. The current FSM administration under President Manny Mori is addressing crucial matters – the slow pace of infrastructure growth, performance assessment, economic reform, and improvements to conditions in Chuuk – with new energy and focus.

It is important to emphasize that the goals of the Compact are to assist the government of the FSM to promote the economic advancement and budgetary self-reliance of its people. With Compact financial support limited to six important sectors, it was never intended to underwrite the entire FSM economy nor all of the operations of its national and state governments. The Compact was intended to be an economic springboard and to a lesser extent a safety net for the FSM.

As a springboard, the Compact provides the resources to allow the FSM to improve essential government services and infrastructure while it reforms its business climate, fiscal policies and improves its capacity to govern. As a safety net, the substantial Compact resources can serve as a disincentive for making those reforms. They can create an illusion that the status quo can be maintained, even in the face of annual decrements to grant funding. In the first five years, the FSM has far too often taken refuge in the safety net, putting much effort into maintaining government payrolls at the expense of effective programs and has not expeditiously taken steps toward reform and economic development. The result is lost time, lost opportunities, a declining economy and a continuing over-reliance on public sector employment.

The Compact and its related agreements create a workable framework for promoting economic advancement and increased budgetary self-reliance. However no arrangement can be successful unless all parties are committed to the framework and comply with the agreements. In the view of Interior officials, the FSM governments often have not complied with our agreements. This deficiency has been especially visible in four areas: in providing coherent and accurate budgets, in performance and economic reporting, in organizing to implement the infrastructure grant program, and in adhering to the purposes of the following sector grants: Public Sector Capacity Building, Environment, and Private Sector Development. Some of the shortfalls can be attributed to gaps in capacity in the FSM governments, but others have resulted from institutional unwillingness to adapt to the changes negotiated in the amended Compact.

In 2004 through 2008, the FSM targeted Compact grant funding largely according to the Compact's priorities, allocating 35 percent of the funds for education, 27 percent for infrastructure, and 22 percent for health. However, the FSM has completed only three infrastructure projects, and more than $67 million of the $82 million (approximately 83 percent) allocated for infrastructure grants in 2004 through 2007 remain unspent. Lack of progress in this sector is the result of national and state disagreements over infrastructure priorities, problems associated with the national government's project management unit, and Chuuk's inability to secure land leases. Unspent funds for other sector grants from 2004 through 2007 amount to an additional $14.9 million or around 7 percent of funds allocated.

The FSM still struggles effectively to use the Public Sector Capacity Building (PSCB), Environment (ENV) and Private Sector Development (PSD) sector grants as they were negotiated. United States negotiators intended that these three sectors, while important, would be funded at levels significantly lower than the other three and would be used for targeted, short-term projects with defined purposes and performance goals. This reflected the United States' intention that the range of operational support provided under the amended Compact was not to be as broad as that of the first Compact and that, other than in the health and education sectors, most aspects of the FSM's government operations would not continue to be funded by U.S. assistance.

As the amended Compact was implemented, the FSM requested that JEMCO allow FSM a transitional period to adapt to the limited operational support provided by the amended Compact. The FSM's fiscal year 2004 Capacity Building grant proposal included basic operations funding of $10.6 million for the national and state governments that did not comply with the Compact agreement. The FSM stated that its non-Compact resources were too limited to maintain certain critical basic operations without which Compact programs could not be supported The JEMCO's decision in August 2003 accepted the FSM's rationale for funding for fiscal year 2004 and required a five-year phased reduction in non-compliant operations funding. That five-year period is now at end, but the FSM has yet fully to develop the economic, fiscal and public sector reforms to meet its operational requirements. Some recent fiscal year 2009 sector proposals still seek funding for non-compliant activities. Some of the FSM states also continue to propose Environment and Private Sector Development grants that seek no more than to cover the recurring costs of government offices whose output is ill-defined and only very loosely related to the purposes of these sectors. We do not expect to recommend that JEMCO support such projects in fiscal year 2009.

At the same time, there is a long list of obvious needs to which FSM can commit PSCB, ENV and PSD funds that can help alleviate key challenges in these sectors. For economic progress, the FSM must initiate substantial reform of its tax and fiscal policy, the public sector and public sector enterprises, land titling and foreign investment. The FSM, however, has not taken action in these areas that are so crucial to its economic well-being. The government lacks expertise in economic planning for growth and for declining U.S. assistance, yet does not seek to allocate the funding that has been established for that purpose. It seeks instead to find ways to maintain public sector payrolls as an apparent first priority.

As noted above, results to date on the use of the Infrastructure Sector Grant have been disappointing. The FSM has not profited from new facilities and employment that could have been gained from an active capital improvements program. Progress in this sector has been hampered by a number of factors. The FSM has not produced an implementable nationwide infrastructure development plan that is prioritized and focused upon the replacement, renovation or repair of education and health facilities throughout the nation. Without such a roadmap, the selection of projects has often been ad-hoc and based upon short-term needs. The selection and prioritization of projects should be developed through a strategic approach.

The FSM has been very slow in accepting a process-based approach for (1) infrastructure project selection, (2) development and adherence to recognized, professional construction and safety standards, and (3) project implementation. The FSM continues to resist prioritization of projects based on need. It prefers to award funds on a formulaic basis among the four states of the FSM. The FSM has also failed to address the key obstacle of access to public land for education and health facilities. This single factor continues to prevent the implementation of critically-needed projects in Chuuk State, where almost every school needs to be replaced. The FSM's failure to contribute matching funds ($6 million since 2004) to the Infrastructure Maintenance fund has also frustrated the Compact's goal of institutionalizing maintenance practices by the governments.

Nevertheless, it appears that the current administration of the FSM National Government recognizes the numerous challenges listed above and is actively engaged in addressing these issues. FSM President Mori has made implementation of Compact-funded infrastructure projects a top priority. Several qualified architectural and engineering firms are under contract with the FSM to provide professional project designs. We are encouraged at the progress that has been made in recent months with regard to moving infrastructure projects forward in three of the four state governments. We expect to see more progress in the months ahead.

The largest single sector funded under the amended Compact is education. The guiding principle of the Compact is that improvements in health and education will create a better workforce at home and bring more remittances from abroad and that these factors, together with improved infrastructure, will provide a foundation for long-term private sector economic development. In the FSM, the states, for the most part control education. As a consequence of this decentralization, there are differing approaches to education, with different results in each state. The FSM's national government and the state departments of education have struggled to develop comprehensive strategic education plans. Officials of the Departments of the Interior and Education and FSM education personnel met earlier this year. The United States officials were encouraged that FSM educators from both the national and state governments will be working on developing more effective educational plans for improving the quality of basic education, including priorities, goals and objectives,. A new national secretary of education, Mr.

Casiano Shoniber, took office this year. While serving as Pohnpei State Director of Education, Mr. Shoniber made significant strides in improving education there. His appointment to national office is expected to strengthen the management of education at the national level and improve the relationship and coordination between the national government and the respective state departments of education.

Since the implementation of the amended Compact, state departments of education no longer operate school systems without textbooks. The states have purchased textbooks and related instructional materials in the four major subject areas of language arts, mathematics, science and social studies. In fiscal years 2005 through 2008, the state departments of education prepared textbook procurement procedures, designed multi-year textbook purchasing plans, budgeted annually for the textbooks, ordered and disseminated the books and instructional materials, and provided training for use of the textbooks. An updated, national textbook inventory will be completed by July 31, 2008.

It has been a common practice of many administrative offices to hire additional staff without the benefit of an analysis of actual staffing needs. To address this issue, which results in excessive funds being spent on unnecessary personnel, the Education sector grant's terms requires the National Department of Education to conduct personnel audits in each state. Work commenced in Chuuk in fiscal year 2008 that will be completed in fiscal year 2009. A personnel audit will commence in Yap in fiscal year 2009. The new Secretary of Education has expressed the need for an immediate personnel audit at the national level. In future fiscal years, personnel audits will also be conducted in Pohnpei and Kosrae states. The intent is to provide administrators with decision-making data for reducing staff and improving efficiencies.

There are other areas of improvement in education that are worth reporting to the committee. Kosrae Department of Education (KDOE) has taken the lead in community involvement and site-based management. Budget trends show increasing amounts allocated to schools for expenditures based on local decisions.

Via email, Pohnpei Department of Education (PDOE) collects attendance and other school data on a daily basis from 36 schools. Data are directly imported to a central data base, obviating cumbersome manual tabulation.

PDOE has developed standards-based assessments that yield achievement data at the student, classroom, and school levels. Student achievement information is disseminated to parents, and school rankings based on the data are disseminated via a regular radio broadcast that deals with educational issues. Decisions on teachers' need for professional development are being made by analyzing student achievement at the classroom level.

PDOE has taken advantage of the flexibility of Supplemental Education Grant funding to establish a collaborative arrangement with the Guam Trades Academy (GTA). GTA has certified and monitors Pohnpei's high school vocational teachers as they deliver a curriculum recognized nationally in the United States. Through this collaboration and at little cost, Pohnpei has ensured that vocational students receive a portable credential upon completion of their coursework.

Yap Department of Education (YDOE) leads the FSM in using solar power to operate computers in remote areas. By investing in solar panels and training teachers in classroom computer applications, students in Yap have access and are gaining skills with contemporary technology.

After years of neglect, Chuuk Department of Education (CDOE) is taking slow but steady steps to improve teaching and facilities.

A remaining, significant weakness of the FSM education systems is the under-education of the teaching staff. Two states, Chuuk and Yap, continue to employ approximately 50% of their teaching staff without an AA or AS degree. An FSM law requires that all teachers must have at least an AA or AS degree by November 2008. Pohnpei and Kosrae will meet the requirement. It is expected that hundreds of teachers in Chuuk and Yap will not meet the mandate. With no qualified substitutes currently available, it is not clear what administrators will do.

The higher cost of fuel and utilities is severely affecting the ability of education departments to maintain properly functioning school systems. The cost of fuel, topping $6.00 per gallon in some jurisdictions, is restricting central office staff from making routine trips to outer islands to conduct teacher training, to deliver textbooks and related teaching supplies, to collect data, and to conduct annual student testing. The increasing cost of electricity is causing electricity brown-outs. Random power disables teachers' ability to conduct computer classes and disrupts administrators' ability to send or receive faxes, and to complete and electronically transmit required reports with any consistency.

Education data remain difficult to obtain, especially from outer islands, resulting in gaps in the performance data. The majority of FSM education administrators are uncomfortable with data collection and analysis. The quality of data submitted by the FSM remains questionable.

Despite the challenges facing the FSM, the lack of quality performance data, and the generally poor condition of the schools throughout the country, FSM education systems are taking small steps to serve the country better.

The FSM has been more effective in using the health sector Compact funding. The sector grant for health is the FSM's third largest, trailing only education and public sector infrastructure development. The Compact gives the FSM wide latitude in determining how and where to apply its grant resources, and health has been a consistent priority. However, operating budgets seem driven by maintenance of existing efforts rather than being driven by the achievement of performance objectives and the encouragement of improvements. Ensuring sufficient funding for fuel, utilities, and other health and medical operations commodities that are highly vulnerable to inflation pressures is an annual budgeting challenge. JEMCO often adds to FSM-proposed budget allocations to assure adequate resources.

Performance data are being developed and maintained in the health sector. The FSM keeps track of fourteen overall health system performance measures that all departments chose for accountability purposes at the start of the amended Compact. Data collection and tabulation methods can still be upgraded. Sustained progress in achieving incremental targets is by no means uniform, but improvements in extremely critical areas are discernible.

Importantly, the health departments in all four states report that it is no longer the norm that they are without drugs, medical supplies, and functioning diagnostic equipment. Essential staffing levels have improved. Immunization rates for children under two years of age are rising and off-island referral costs for tertiary treatment are more manageable. Although still a major and costly problem, routine diabetic hospitalization no longer seems to crowd out other in-patient hospital care needs.

Despite these achievements, the health sector is challenged by shortages in financial and human resources in almost all areas. The states often forgo facilities maintenance and repair when dollars must first be spent on pharmaceutical and medical supply purchases, salaries, utilities, and fuel.

The fiscal and economic future of the FSM is of concern to the United States members of the JEMCO. The FSM has limited prospects for achieving budgetary self-reliance and long-term economic advancement, and the FSM government has not yet implemented policy reforms needed to enable economic growth. The FSM economy depends on public sector spending of foreign assistance. Government expenditures, two-thirds of which are funded by external grants, account for more than half of the FSM's gross domestic product (GDP). The FSM government's budget is characterized by limited tax revenue and a growing wage bill, and the two private sector industries identified as having growth potential—fisheries and tourism—face significant barriers to expansion because of the FSM's remote geographic location, inadequate infrastructure, and poor business environment.

Progress in implementing key tax, public sector, land, and foreign investment policy reforms necessary to improve growth has been slow. For example, although the FSM has agreed on principles of reform to address its inefficient and inequitable tax system, the FSM government has made limited progress in implementing fundamental tax reform. Also, the FSM's failure to implement key public sector reforms to reduce wage and subsidy expenditures resulted in fiscal crisis in Chuuk and Kosrae. The short-term solutions to this problem, reducing the government work force and insisting on balanced budgets, while necessary, are precursors of more rounds of cuts unless the economic growth can be stimulated.

An important element of the United States financial assistance under the Compact is the Trust Fund established to contribute a source of revenue to the government for the FSM when annual sector grants cease after 2023. Trust Fund proceeds will be used for the same purposes as the annual sector grants.

As of April 30, 2008, the market value of total assets of the FSM Trust Fund was $135.91 million. Of that amount, $115.6 million represented contributions of governments, including $85.3 million from the United States and $30.3 million from the FSM. The return on assets during the current fiscal year from Sept. 30, 2007, to April 30, 2008, has been about -5 percent.

Since Mercer Investment Consulting began managing the Trust Fund assets as investment adviser in August 2006, the Fund's investments have returned 17.6 percent in fiscal year 2007 and -5 percent in the current fiscal year through April. The assets have been invested in a mix of United States public equity, international equity funds, fixed income funds and private real estate.

The Trust Fund Committee continues to investigate possible securitization of future U.S. contributions to the Trust Fund, with the objective of increasing the 2023 value of the fund assets and has obtained a study of its potential benefits and risks. Securitization would permit the Trust Fund to invest with a longer time horizon by bringing forward the United States contributions scheduled for later years but at a cost. If deemed advantageous, a change in the Compact law would be necessary in order to permit implementation of a securitization program.

The JEMCO will meet in Washington in late August to allocate fiscal year 2009 grant funds and discuss progress in the FSM. OIA grant managers this week completed budget consultations with the FSM national government and each state government. Their findings and recommendations will be reported to JEMCO for it to make its 2009 allocation decisions. The group still finds the FSM grappling with plans for Capacity Building, Environment and Private Sector development grants but notes progress in budget presentations in Education and Health. In addition, the FSM is prepared to move into the initial phases of ten new infrastructure projects.

In conclusion, the FSM faces very serious challenges. Its challenges are not resources; it has the financial resources to implement a large and important program of improvement to schools, health facilities and other critical infrastructure, with beneficial effect for the FSM's economy. What the FSM needs is the will to use its resources as a springboard to better sector performance and improved economic growth.