COMPACT OF FREE ASSOCIATION: MICRONESIA FACES CHALLENGES TO ACHIEVING COMPACT GOALS

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House Committee on Natural Resources, Insular Affairs Subcommittee
David Gootnick, Director, International Affairs and Trade Team
Government Accountability Office

Madame Chairwoman and Members of the Subcommittee:

I am pleased to be here today to discuss GAO's recent work regarding the amended Compact of Free Association between the United States and the Federated States of Micronesia (FSM).[1]

From 1987 through 2003,[2] the FSM received more than $1.5 billion in economic assistance under the original Compact of Free Association with the United States.[3] In 2003, the U.S. government approved an amended compact with the FSM that provides an additional $2.3 billion from 2004 through 2023.[4] The Department of the Interior's Office of Insular Affairs (OIA) is responsible for administering and monitoring this assistance.

The amended compact identifies the additional 20 years of grant assistance as intended to assist the FSM in its efforts to promote the economic advancement and budgetary self-reliance of its people. The assistance is provided in the form of annually decreasing grants that prioritize health and education, paired with annually increasing contributions to a trust fund intended as a source of revenue for the country after the grants end in 2023.[5] The amended compact also contains several new funding and accountability provisions intended to strengthen reporting and bilateral interaction. Among these provisions is a requirement for the establishment of a joint economic management committee and a trust fund committee to, respectively, among other duties, review the FSM's progress toward compact objectives and assess the trust fund's effectiveness in contributing to the country's economic advancement and long-term budgetary self-reliance. In

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[1]The FSM comprises four states—Chuuk, Kosrae, Pohnpei, and Yap—with 50 percent of the FSM population residing in Chuuk state. A list of relevant GAO reports on the FSM is included in attachment I.

[2]In this testimony, all years cited are fiscal years (Oct. 1–Sept. 30).

[3]Under the original Compact of Free Association, the United States also provided about $579 million of economic assistance to the Republic of the Marshall Islands (RMI). In 2000, we reviewed assistance under the compact and determined that the U.S., FSM, and RMI governments had provided limited accountability over spending and that U.S. assistance had resulted in little impact on economic development in the FSM and RMI. See GAO/NSIAD-00-216.

[4]This figure is based on a Department of the Interior projection included in its Fiscal Year 2009 Budget Justification. The United States also signed an amended compact with the RMI that provides about $1.5 billion from 2004 through 2023.

[5]According to U.S. officials, the trust fund income is intended to be one source of income, and the amended compact does not guarantee that the trust fund will provide the maximum disbursements allowed by the trust fund agreements.

2003, we testified that these provisions could improve accountability over the assistance provided but that successful implementation of these provisions would require appropriate resources and sustained commitment from both the United States and the FSM.[6]

Today, drawing on several more recent reports as well as updated information,[7] I will discuss the FSM's economic prospects, implementation of the amended compact to meet its long-term goals, and potential trust fund earnings.

Summary

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, over half of which are funded by external grants, account for about 65 percent 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. Moreover, 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 tax system that has been characterized by experts as inefficient and inequitable, 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. In August 2006, nearly 2 years after the amended compact entered into force, the FSM Joint Economic Management Committee (JEMCO) began discussions of economic policy reform and has since approved some funding to support FSM reform efforts; however, challenges to private sector growth remain.

Numerous factors have negatively affected the use of the compact grants for FSM development goals. The FSM's grant allocations have reflected compact priorities by targeting education, health, and infrastructure. However, as of April 2008, the FSM had completed only three infrastructure projects and approximately 82 percent of the $82.5 million in infrastructure funds remained unexpended. Lack of progress in this sector is owed to national and state disagreements over infrastructure priorities, problems associated with the project management unit, and Chuuk's inability to secure land leases. Additionally, the FSM has almost $15 million in unspent funds for other sectors, or around 7 percent of funds allocated from 2004 to 2007. Furthermore,

[6]See GAO-03-988T, a testimony before the Committee on Resources, House of Representatives.

[7]The amended compacts' implementing legislation instructs GAO to report 3 years following the enactment of the legislation and every 5 years thereafter on the FSM's use and effectiveness of U.S. financial, program, and technical assistance as well as the effectiveness of administrative oversight by the United States. To update information for this testimony, we met with U.S. and FSM officials and reviewed documentation from, among other things, the April 2008 technical working group and the FSM's 2007 economic report. We conducted these performance audits in accordance with generally accepted government auditing standards. See list of related GAO products in attachment I.

the FSM's distribution of grants among its four states has not been based on need, leading to significant differences in per capita funding, while the FSM's long-term planning has not taken into account the likely effects of the annual funding decrement and other budgetary changes. The FSM has also lacked accountability for the use of compact funds, as demonstrated by weaknesses in its yearly financial statements and lack of compliance with requirements of major federal programs. Moreover, the FSM has not consistently monitored day-to-day grant operations or reported on progress toward program and economic goals, owing to inadequate data, a lack of required reporting, and an unwillingness to dedicate the resources necessary. OIA has conducted administrative oversight of the sector grants, but its oversight has been constrained by the need to assist the FSM with its compact implementation activities such as preparing budgets and addressing financial management problems such as the misuse of compact funds by Chuuk and Kosrae in 2006 and 2007, respectively.

The FSM's trust fund may not provide sustainable income for the country after compact grants end—a potential outcome that the FSM trust fund committee has not yet addressed. Market volatility and the choice of investment strategy could cause the FSM trust fund balance in some years to fall short of the maximum disbursement level allowed—an amount equal to the inflation-adjusted compact grants in 2023—or to be unable to disburse any income. Moreover, the probability of shortfalls increases over time. The trust fund income could be supplemented from several sources, including funding from other donors, increased tax revenue, or securitization. However, the FSM has not attracted other donors, its limited development prospects constrain its ability to raise tax revenues, and securitization—issuing bonds against future U.S. contributions—carries the risk of lower fund balances and reduced income. Furthermore, because management challenges affecting the FSM trust fund committee delayed the fund's investment, the fund remained in a low-interest savings account for 22 months. Additionally, despite the likely impact of market volatility and investment strategy on the trust fund balance, the trust fund committee has not assessed the fund's potential adequacy as a source of revenue after the compact grants end in 2023.

Our previous reports on the amended compacts recommended, among other things, that Interior's Deputy Assistant Secretary for Insular Affairs ensure that the compact management committee addresses the FSM's lack of progress in implementing economic reforms; work with the FSM to develop plans for minimizing the impact of the declining grants; work with the FSM to fully develop a reliable mechanism for measuring progress toward compact goals; and ensure the trust fund committee's timely reporting on the fund's likely status as a source of revenue after 2023. Interior generally concurred with our recommendations and has taken some actions in response to several of them, although key challenges to effective compact implementation remain unaddressed.

Background

Compact of Free Association: 1986-2003

In 1986, the United States entered into its original Compact of Free Association with the FSM.[8] The compact comprised a framework for the United States to work toward achieving three main goals: (1) to secure self-government for the FSM, (2) to ensure certain national security rights for all parties, and (3) to assist the FSM in its efforts to advance economic development and self-sufficiency. Under the original compact, the FSM also benefited from numerous U.S. federal programs, and their citizens were allowed to live and work in the United States as nonimmigrants and to stay for long periods of time.

Although the original compact's first and second goals were met, the FSM did not achieve economic self-sufficiency. The FSM gained independence in 1978, and key defense rights were established. However, the compact's third goal was to be accomplished primarily through U.S. direct financial assistance totaling about $1.5 billion from 1987 through 2003.[9] Although U.S. financial assistance maintained higher income levels than the FSM could have achieved without support, FSM estimated per capita GDP at the compact's close did not differ substantially, in real terms, from its per capita GDP in the early 1990s.[10] In addition, we found that the U.S. and FSM governments provided little accountability over compact expenditures and that many compact-funded projects encountered problems related to poor planning and management, inadequate construction and maintenance, or misuse of funds.[11]

Amended Compact of Free Association: 2004-2023

In 2003, the United States approved an amended compact with the FSM that (1) continues the defense relationship; (2) strengthens immigration provisions; and (3) provides an estimated $2.3 billion to the FSM for 2004 through 2023 (see attachment II). The amended compact, which took effect in June 2004, identifies the additional 20 years of grant assistance as intended to assist the FSM in its efforts to promote the economic advancement and budgetary self-reliance of its people. Financial assistance is provided in the form of annual sector grants and contributions to the trust fund. [12] The amended compact and its subsidiary agreements, along with the FSM's development plan, target the grant assistance to six sectors—education, health, public

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[8]Under the initial Compact of Free Association, the United States also entered into a compact with the RMI, with a similar set of goals and compact framework.

[9]This estimate represents total nominal outlays. It does not include investment development funds provided under section 111 of Public Law 99-239 or the cost of compact-authorized federal services.

[10]In fiscal year 2003 dollars, estimated FSM per capita GDP was around $2,150 in 2003, compared with an average of around $2,120 in 1991-1995. See GAO-06-590.

[11]See GAO/NSIAD-00-216.

[12]U.S. contributions to trust funds were conditioned on the FSM making its own required contribution. The FSM made its required initial contribution of $30 million to its trust fund on October 1, 2004, one day after the September 30, 2004 deadline.

infrastructure, the environment, public sector capacity building, and private sector development—prioritizing two sectors, education and health.[13] To provide increasing U.S. contributions to the FSM's trust fund, grant funding decreases annually and will likely result in falling per capita grant assistance over the funding period and relative to the original compact (see attachment III). For example, in 2004 U.S. dollar terms, FSM per capita grant assistance will likely fall from around $1,352 in 1987 to around $562 in 2023.

Under the amended compact, annual grant assistance is to be provided according to an implementation framework with several components (see attachment IV). For example, prior to the annual awarding of compact funds, the FSM must submit a development plan that identifies goals and performance objectives for each sector. The FSM government is also required to monitor day-to-day operations of sector grants and activities, submit periodic financial statements and performance reports for the tracking of progress against goals and objectives, and ensure annual financial and compliance audits. In addition, the U.S. and JEMCO are to approve annual sector grants and evaluate the countries' management of the grants and their progress toward program and economic goals. The amended compact and subsidiary trust fund agreement also provide for the formation of an FSM trust fund committee to, among its other duties, hire a money manager, oversee the fund's operation and investment, and provide annual reports on the fund's profitability.

FSM Economic Prospects Remain Limited

The FSM economy shows limited potential for developing sustainable income sources other than foreign assistance to offset the annual decline in U.S. compact grant assistance. Moreover, the FSM has not enacted economic policy reforms needed to improve its growth prospects.

The FSM's economy shows continued dependence on government spending of foreign assistance and limited potential for expanded private sector and remittance income.

- Total government expenditures in 2006, over half of which were funded by external grants, accounted for about 65 percent of GDP.
- The FSM's government budget is characterized by limited tax revenue paired with growing government payrolls. For example, FSM taxes have consistently provided less than 25 percent of total government revenue; however, payroll expenditures have increased as a percentage of total government spending, from 38 percent in 2000 to 45 percent in 2006.
- The FSM development plan identifies fishing and tourism as key potential private sector growth industries. However, the two industries together provide only about 6 percent of employment. Further, according to economic experts, growth in these industries is limited by factors such as the FSM's geographic isolation, lack of tourism infrastructure, inadequate interisland shipping, limited pool of skilled labor, and growing danger of overfishing.

[13]In the compacts' implementing legislation, Congress also suggested that the FSM allocate for infrastructure improvement and maintenance at least 30 percent of its total sector grant allocation.

- Although remittances from emigrants could provide increasing monetary support to the FSM, evidence suggests that FSM emigrants are currently limited in their income-earning opportunities abroad, owing to inadequate education and vocational skills.

Although the FSM has undertaken some efforts aimed at economic policy reform, it has made limited progress in implementing key tax, public sector, land, and foreign investment reforms that are needed to improve its growth prospects. For example:

- *Tax reform.* After several years of national policy dialogue to address a tax system that economic experts describe as inequitable and inefficient, the FSM established a tax reform executive steering committee in December 2005. The committee endorsed key elements of tax reform recommended by experts and the FSM's Tax Reform Task Force, such as a value-added tax (VAT), a net profit tax, and a unified tax authority. In April 2007, the committee endorsed a 3-year implementation plan. However, as of April 2008, legislation required for implementing these measures had not yet been passed.
- *Public sector reform.* Although the FSM has endorsed public sector reform aimed at reducing wage and subsidy expenditures, limited progress has been made in addressing annual fiscal deficits, which amounted to about 5 percent of GDP in 2005 and 2006. Slow progress in implementing public sector reforms, combined with a lower level of grant assistance, precipitated fiscal crises in Kosrae and Chuuk. Fiscal adjustment programs were subsequently created for the two states based on, among other things, reductions-in-force wage savings and increased state tax rates. Kosrae completed its adjustment program in 2007, but Chuuk's implementation of its program began only recently.[14] Moreover, all FSM governments continue to conduct a wide array of commercial enterprises that require subsidies.
- *Land reform.* In attempts to modernize a complex land tenure system, the FSM has established land registration offices. However, these offices have lacked a systematic method for registering parcels, instead waiting for landowners to voluntarily initiate the process. Continued uncertainties over land ownership and land values create costly disputes, disincentives for investment, and problems regarding the use of land as an asset.
- *Foreign investment reform.* Economic experts and private sector representatives describe the overall climate for foreign investment in the FSM as complex and nontransparent. Despite attempts to streamline the process, foreign investment regulations remain relatively burdensome, with reported administrative delays and difficulties in obtaining permits for foreign workers**.** Some FSM states also require a certain percentage of local ownership in foreign investment.

Although the FSM development plan includes objectives for economic reform, JEMCO did not begin to address the country's slow progress in implementing these reforms until August 2006, 2 years into the amended compact. Further, while JEMCO recently approved some funding to

[14]Chuuk's debt levels currently amount to about $37 million, and the anticipated time required to complete its adjustment program, including the servicing of this debt, is 5 to 7 years. Chuuk's efforts to reduce its public sector workforce are ongoing. Although Chuuk has reduced the work week for certain public sector employees, the list of positions for elimination has not yet been published.

support FSM efforts at public sector reform,[15] key challenges to improving private sector growth remain.

Numerous Factors Hinder Use of Compact Funds to Advance FSM Development Goals

Although the FSM has allocated compact grants to the sectors targeted by the compact, immediate problems in some sectors persist, and several factors have hindered the FSM's use of the funds to meet long-term development goals. In addition, administrative deficiencies have limited the FSM's ability to account for its use of the grants for these long-term goals. Further, although OIA has monitored early compact activities, program implementation challenges have hampered its oversight.

In 2004 through 2008, the FSM targeted compact grants largely according to compact priorities,[16] allocating 35 percent of the funds for education, 27 percent for infrastructure, and 22 percent for health (see attachment V). However, the FSM has completed only three infrastructure projects, and more than $67 million of the $82.5 million (approximately 82 percent) allocated for infrastructure grants in 2004 through 2007 remains unspent. Lack of progress in this sector is owed to national and state disagreements over infrastructure priorities, problems associated with the project management unit, and Chuuk's inability to secure land leases.[17] Unspent funds for other sector grants from 2004 to 2007 amounts to an additional $14.9 million, or around 7 percent of funds allocated (see attachment VI).
Additionally, numerous factors have limited the government's use of compact funds to meet long-term development needs. For example:

- *Lack of government consensus.* Interior and State officials reported that the FSM's weak federal structure inhibits compact grant implementation. Because each state has its own constitution and authority over budgetary policies, the FSM central government, which is represented on JEMCO, does not control the majority of compact funds and has been unable to secure agreement from the state governments regarding the use of compact funds.
- *Lack of needs analysis.* The allocation of FSM grants among its four states is not needs based and has resulted in significant differences in per capita funding, creating varying levels of government services across the states.[18] For example, in 2006, Yap state received approximately $1,963 in education funding per student, while Chuuk state received $626 per student. More recently, in 2007, the national government's share of

[15] In August 2007 and February 2008 respectively, JEMCO approved use of public-sector capacity building grant funds to provide one-year's annual salary as a buy-out to support public sector reforms in Kosrae and Chuuk.

[16] The priority for infrastructure spending was designated by a sense of the U.S. Congress laid out in the Compact's enabling legislation.

[17] Additionally, only Pohnpei has contributed to the FSM infrastructure maintenance fund. None of the other states have made their required contribution to this fund and are therefore unable to use it.

[18] The FSM distributed overall compact funding among its four states according to a formula established in an FSM law enacted in January 2005 and in force through 2006 that allotted a set percentage to each state and the national government without fully accounting for states' differing population sizes or funding needs. The states decide their own distribution of funds between the sectors, from their allocation.

grant funding increased from 8.65 percent to 10 percent and the allocation of compact funds to the four states decreased.

- *Lack of planning for declining U.S. assistance*. A lack of viable plans to address the annual decrement in compact funding and the elimination of nonconforming uses of the public-sector capacity building (PSCB) grant could limit the FSM's ability to sustain current levels of government services.[19] JEMCO required the FSM in 2004 to develop a plan to eliminate funding for the nonconforming uses of the PSCB by 2009. While FSM officials indicated that they plan to replace the PSCB funds with local monies, recent tax revenues have largely stagnated and, in 2006, the FSM requested that the deadline for its elimination of nonconforming funding be extended to 2011. OIA indicated that the steps the FSM takes toward overall public sector reform will affect whether it recommends to JEMCO to approve this request.
- *Lack of accountability over compact funds.* The FSM's accountability for its use of compact funds has been limited. Although the timeliness of the FSM's single audits has improved—in 2006, only Chuuk and the national government submitted audit reports after the deadlines—auditors have continued to find weaknesses with financial statements and lack of compliance with requirements of major federal programs. For example, the lack of audited financial statements for several subgrantees led the auditors to render qualified and disclaimed opinions.[20]

The FSM has failed to consistently monitor day-to-day sector grant operations or report on progress.

- *Inadequate authority*. The FSM's first effort to monitor and report on compact progress was through the Office of Compact Management (OCM), which lacked the authority and resources to carry out its function. In 2007, the FSM created a Statistics, Budget and Overseas Development Assistance and Compact Management (SBOC) office. According to OIA, the SBOC may have a role in conducting compact coordination, ensuring sector-by-sector compliance, and providing technical assistance to the states. Nonetheless, as of April 2008, SBOC had not addressed performance problems, such as missing reports and data, and had failed to hold the FSM governments accountable for not meeting JEMCO resolutions and grant requirements.
- *Data deficiencies*. Although the FSM established performance measurement indicators, a lack of complete and reliable data prevents the use of these indicators to assess progress. For example, the FSM provided the first complete set of education indicators in 2007. However, OIA found that the data were not consistently reliable for monitoring scholastic improvements, owing to problems in establishing baselines and collecting data for all of

[19]The FSM has been using PSCB funds to support basic government operations, rather than for the grant's intended purpose to support the efforts of the FSM to develop internal expertise needed to build an effective, accountable, and transparent government.

[20]A "qualified" opinion is given when the auditor finds conditions, such as a lack of supporting evidence or a restriction on the scope of the audit. An auditor issues a "disclaimer" of opinion when unable to perform all of the procedures necessary to complete an audit, indicating the reliability of the financial statements is not known. An "adverse" opinion is given when the auditor concludes that the financial statements are not fairly presented. Pohnpei and Kosrae states' reports for 2006 contained an unqualified opinion on the financial statements. However, other reports contained qualified, adverse, or disclaimed opinions.

the indicators. Likewise, determining performance in the health sector was difficult due to a lack of standardized data collection.

- *Report problems*. The FSM continues to have difficulty in submitting its required annual report to the U.S. President on time. As of April 2008, the FSM had not begun work on the 2007 annual report to the U.S. President, which was due in February 2008, and it submitted the 2006 annual report 10 months late. The quarterly reports have also been regularly incomplete or inconsistent, preventing their use for monitoring progress. Most recently, OIA rejected the FSM's 2007 fourth quarter reports, stating that most of the submitted forms were completely blank or missing data.
- *Capacity constraints*. The FSM has not allocated available compact resources to develop the capacity for, and to provide, regular monitoring of sector grants. As a result, the skills necessary to improve financial and programmatic reporting are lacking. For example, the FSM's single audit reports for 2005 and 2006 showed that the FSM's ability to account for the use of compact funds was limited, as shown by weaknesses in its financial statements and lack of compliance with requirements of major federal programs. The FSM's Compact Fiscal Adjustment and Transition Plan, in August 2006, reiterated that capacity weaknesses continue, especially in the areas of financial management, economic planning, and statistics.

OIA has carried out various duties as administrator of the amended compact grants but has not addressed the FSM's worsening compliance with compact reporting requirements, and several challenges continue to hamper its compact oversight. For example, in monitoring the sector grants, OIA determined that Chuuk, in 2006, and Kosrae, in 2007, had each misused approximately $1 million in compact funds through the commingling of compact and general funds. OIA required both states to repay the misused funds, a requirement met in 2007. However, OIA has generally failed to hold the FSM accountable for not submitting required reports, including 2006 and 2007 quarterly performance reports and the annual report to the U.S. President, and for not meeting requirements imposed as grant conditions by JEMCO. Additionally, OIA's oversight continues to be constrained by time-consuming demands associated with poor compact implementation. For example, because the FSM state and national government budgets are not presented in unified format or linked to performance measures, OIA reports that it has continued to spend an inordinate amount of time reviewing them for the JEMCO meetings.

FSM Trust Fund May Not Provide Sustainable Income after Compact Grants End

FSM trust fund balances in 2023 could vary widely owing to market volatility and choice of investment strategy, preventing trust fund disbursements in some years. Moreover, the FSM's ability to supplement its trust fund balance with additional contributions or other sources of income is uncertain and entails risks. Further, the FSM's trust fund committee has faced challenges in managing the fund's investment and has not evaluated the fund's adequacy as a source of future revenue.

Market volatility and investment strategy could have a considerable impact on projected trust fund balances in 2023 (see attachment VII). Our analysis indicates that, under various scenarios, the FSM's trust fund could fall short of the maximum allowed disbursement level[21]—an amount equal to the inflation-adjusted compact grants in 2023—after compact grants end, with the probability of shortfalls increasing over time (see attachment VIII).[22] For example, under a moderate investment strategy, the fund's income is about 30 percent likely to fall short of the maximum distribution by 2031; however, this probability rises to almost 70 percent by 2050. Additionally, our analysis indicates a positive probability that the fund will yield no disbursement in some years; under a moderate investment strategy, the probability is around 19 percent by 2050.

FSM trust fund income could be supplemented by sources such as other donors, increased taxes, and securitization. However, this potential is uncertain.

- *Other donors.* The trust fund agreement allows the FSM to seek funding from other donors; however, the FSM has not yet received other contributions.[23]
- *Increased taxes.* The FSM's limited development prospects constrain its ability to raise tax revenues to supplement the fund's income.
- *Securitization.* Securitization—issuing bonds against future U.S. contributions—could increase the fund's earning potential by raising its balances through bond sales. However, securitization could also lead to lower balances and reduced fund income if interest owed on the bonds exceeds investment returns. In October, 2007, the committee contracted for a study of securitization.[24]

The FSM trust fund committee has experienced management challenges in establishing the trust fund to maximize earnings and has not yet evaluated the fund's adequacy as a source of future revenue. Contributions to the trust fund were initially placed in a low-interest savings account and were not invested until 22 months after the initial contribution. The months when the fund remained in a low-interest account prior to investment likely reduced its potential investment earnings significantly; we estimate this loss at $720,000 per month, after taking into account stock market investment fees.[25] As we reported in June 2007, contractual delays and committee

[21]The FSM trust fund agreement specifies that in 2024 and thereafter, the FSM trust fund committee may disburse amounts up to the annual grant assistance in 2023, fully adjusted for inflation, provided that this amount is available.

[22]Our methodology for projecting the trust fund income is base on a technique known as Monte Carlo simulation. We built a Monte Carlo simulation model—based on the trust fund agreements, contributions to date, and historical returns of the market—to project the trust fund's likely income levels given market volatility as well as historical returns of various asset classes, including large company stocks, treasury bills, and international stocks from 1970 to 2005. See GAO-07-513.

[23] In contrast, in May 2005, the RMI and Taiwan reached an agreement that Taiwan will contribute a total of $40 million to the RMI's trust fund from 2004 to 2023.

[24]We previously reported that some members of the trust fund committee believe that securitization could bring great financial benefits, as a company that performs securitization had asserted in presentations to the committee. Others raised concerns of whether the trust fund could pursue securitization under the current amended compact and trust fund agreement or whether amendments to the agreement would be required. See GAO-07-513.

[25]From October 2004 through August 2006, the FSM trust fund—with an October 2005 balance of approximately $80 million—earned about 3 percent interest, compared with potential stock market earnings of about 15 percent. See GAO-07-513.

processes for reaching consensus and obtaining administrative support contributed to the time taken to establish and invest funds. The committee has since hired an Executive Administrator in September 2007, and some steps were taken to improve committee processes; however, the Administrator reports that communication and administrative delays remain. Also, despite the likely impact of market volatility and investment strategy, the trust fund committee's reports have not yet assessed the fund's potential adequacy as a source of revenue for meeting the FSM's long-term economic goals.

Concluding Remarks and Prior Recommendations

Since enactment of the amended compact, the U.S. and FSM governments have made efforts to meet new requirements for implementation, performance measurement, and oversight. However, after 5 years—one quarter of the amended compact's duration—the FSM faces significant challenges in working toward the compact goals of economic advancement and budgetary self-reliance. The FSM economy shows continued dependence on government spending of foreign assistance. However, despite the budgetary impact of declining annual grant assistance, the FSM has made little progress in implementing key reforms needed to improve tax income or increase private sector investment opportunities. The FSM has also been unable to utilize more than $67 million in infrastructure and almost $15 million in other sector grant monies. Moreover, persistent deficiencies in needs assessment, long-term planning, and financial accountability continue to hinder the U.S. and FSM governments and JEMCO from ensuring effective implementation of those grants that have been spent. Although OIA has carried out various duties as administrator of compact grants, U.S. and FSM monitoring of grant operations remains deficient owing to continued problems with oversight authority in the FSM, consistently poor data and reporting, and unaddressed capacity constraints. Further, the FSM trust fund committee has yet to assess the potential status of the trust fund as an ongoing source of revenue after compact grants end in 2023. Because the trust fund's earnings are intended as a main source of U.S. assistance to the FSM after compact grants end, the fund's potential inadequacy as a source of sustainable income in some years could impact the FSM's ability to provide future government services.

To maximize the benefits of compact assistance, our prior reports[26] include recommendations that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as chair of the FSM management and trust fund committees, to take a number of actions, including the following:

- ensure that JEMCO address the lack of FSM progress in implementing reforms to increase investment and tax income;
- coordinate with other U.S. agencies on JEMCO to work with the FSM to establish plans to minimize the impact of declining assistance;
- coordinate with other U.S. agencies on JEMCO to work with the FSM to fully develop a reliable mechanism for measuring progress toward compact goals; and
- ensure the FSM trust fund committee's assessment and timely reporting of the fund's likely status as a source of revenue after 2023.

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[26] GAO-05-633, GAO-06-590, GAO-07-163, GAO-07-513, GAO-07-514R.

Interior generally concurred with our recommendations and has taken actions in response to several of them. However, unless the challenges we identified are addressed, the U.S. and FSM are unlikely to meet compact goals of the FSM's economic advancement and budgetary self-reliance.

Mr. Chairman and members of the subcommittee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

Contacts and Acknowledgements

For future contacts regarding this testimony, please call David Gootnick at (202) 512-3149 or gootnickd@gao.gov. Individuals making key contributions to this testimony included Emil Friberg, Jr. (Assistant Director), Ming Chen, Julie Hirshen, Reid Lowe, Mary Moutsos, Kendall Schaefer, and Eddie Uyekawa.

Attachment I: Related GAO Products

Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income, GAO-07-513 (Washington, D.C.: July 15, 2007).

Compact of Free Association: Micronesia and the Marshall Island's Use of Sector Grants, GAO-07-514R (Washington, D.C.: May 25, 2007).

Compacts of Free Association: Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability, GAO-07-163 (Washington, D.C.: Dec. 15, 2006).

Compacts of Free Association: Development Prospects Remain Limited for the Micronesia and the Marshall Islands, GAO-06-590 (Washington, D.C.: June 27, 2006).

Compacts of Free Association: Implementation of New Funding and Accountability Requirements is Well Under Way, but Planning Challenges Remain, GAO-05-633 (Washington, D.C.: July 11, 2005).

Compact of Free Association: Single Audits Demonstrate Accountability Problems over Compact Funds, GAO-04-7 (Washington, D.C.: Oct. 7, 2003).

Compact of Free Association: An Assessment of the Amended Compacts and Related Agreements, GAO-03-988T (Washington, D.C.: June 18, 2003).

Foreign Assistance: Effectiveness and Accountability Problems Common in U.S. Programs to Assist Two Micronesian Nations, GAO-02-70 (Washington, D.C.: Jan. 22, 2002.

Foreign Relations: Migration From Micronesian Nations Has Had Significant Impact on Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands, GAO-02-40 (Washington, D.C.: Oct. 5, 2001).

Foreign Assistance: U.S. funds to Two Micronesian Nations Had Little Impact on Economic Development, GAO/NSIAD-00-216 (Washington, D.C.: Sept. 22, 2000).

Attachment II: U.S. Assistance to the FSM under the Amended Compact, 2004-2023

(Dollars in millions)

Fiscal year	FSM grants (Section 211)	FSM trust fund (Section 215)
2004	$76.2	$16.0
2005	76.2	16.0
2006	76.2	16.0
2007	75.4	16.8
2008	74.6	17.6
2009	73.8	18.4
2010	73.0	19.2
2011	72.2	20.0
2012	71.4	20.8
2013	70.6	21.6
2014	69.8	22.4
2015	69.0	23.2
2016	68.2	24.0
2017	67.4	24.8
2018	66.6	25.6
2019	65.8	26.4
2020	65.0	27.2
2021	64.2	28.0
2022	63.4	28.8
2023	62.6	29.6

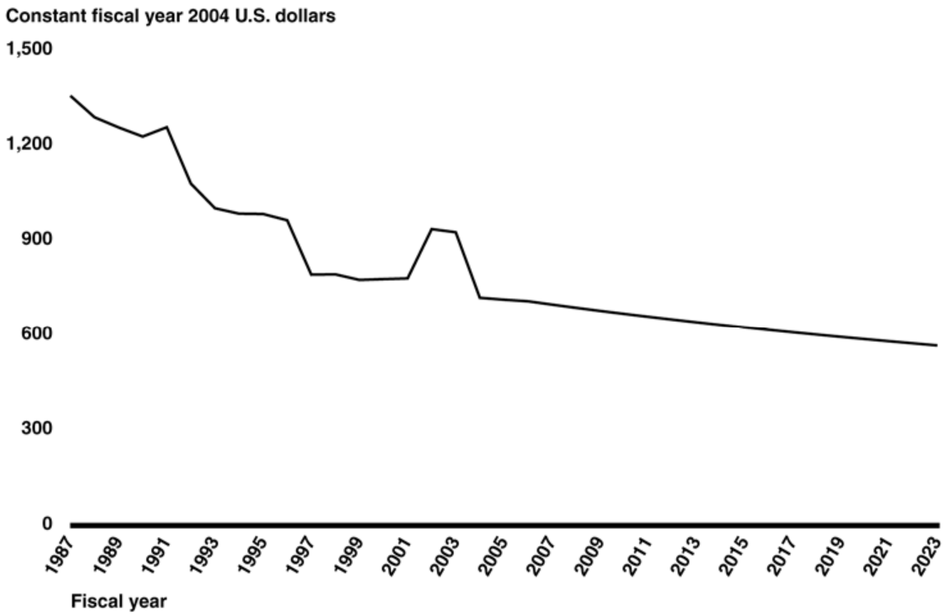
Source: Pub. L. No. 108-188.

Notes:

The annual grant amounts include $200,000 to be provided directly by the Secretary of the Interior to the Department of Homeland Security, Federal Emergency Management Agency, for disaster and emergency assistance purposes. The grant amounts do not include the annual audit grant, capped at $500,000.

These dollar amounts shall be adjusted each fiscal year for inflation by the percentage that equals two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator, or 5 percent, whichever is less in any one year, using the beginning of 2004 as a base. Grant funding can be fully adjusted for inflation after 2014, under certain U.S. inflation conditions.

Attachment III: Estimated FSM Per Capita Compact Grant Assistance, Fiscal Years 1987-2023



Source: GAO analysis of amended compact and U.S. Census population projections.

Note: Compact grant assistance under the original compact decreased in 1991, 1996, and 2001 and increased in 2002 and 2003 to equal an average of the funding provided during the previous 15 years. Compact grant assistance under the amended compacts (2004-2024) decreases annually. U.S. contributions to the FSM's compact trust fund increase by the same amount as the grant decrement. Funding for compact-authorized federal services and trust fund contributions is not included.

Attachment IV: Amended Compact Implementation Framework

Preaward requirements

Country development plan

- Promote economic advancement and budgetary self-reliance
- Be strategic in nature, multiyear, and continually updated
- Identify sector goals and objectives

Annual sector grant budget

- FSM proposes grant budgets for each sector that includes provisions such as:
  - Expenditures, performance goals, and specific performance indicators
  - Breakdown of personnel expenditures and other costs
  - Information on U.S. federal programs and other donors
- United States evaluates the proposed sector grant budgets for:
  - Consistency with funding requirements in the compact and related agreements
  - Appropriateness of performance objectives and indicators
  - Adequacy of expenditures in achieving stated purposes
- United States and the FSM consult regarding the proposed budget, discussing any need for special terms and conditions or adjustment to the annual grant budgets

Joint management and accountability committee JEMCO

- Evaluate progress and management problems in each sector and identify ways to improve the effectiveness of U.S. assistance
- Review audits called for in the compact and review country annual progress reports
- Consult with other donors and U.S. program providers to coordinate the use of development assistance
- Receive and review proposed sector budgets and development plans:
  - Establish special grant terms and conditions to improve program performance and fiscal accountability, and ensure progress toward macroeconomic goals
  - Approve sector grant allocations and performance objectives (The United States awards grants)

Postaward requirements

FSM grant management

Program monitoring

- Monitor to ensure the achievement of performance goals
- Issue uniform quarterly sector performance reports that:
  - Compare actual accomplishments to the objectives and indicators
  - Identify positive events that accelerate performance outcomes and problems encountered and their impact on grant activities and performance measures
- Manage and monitor day-to-day operations to ensure compliance with grant conditions
- Submit annual report to the U.S. President on use of grant assistance and other U.S. assistance and progress in meeting program and economic goals

Financial administration

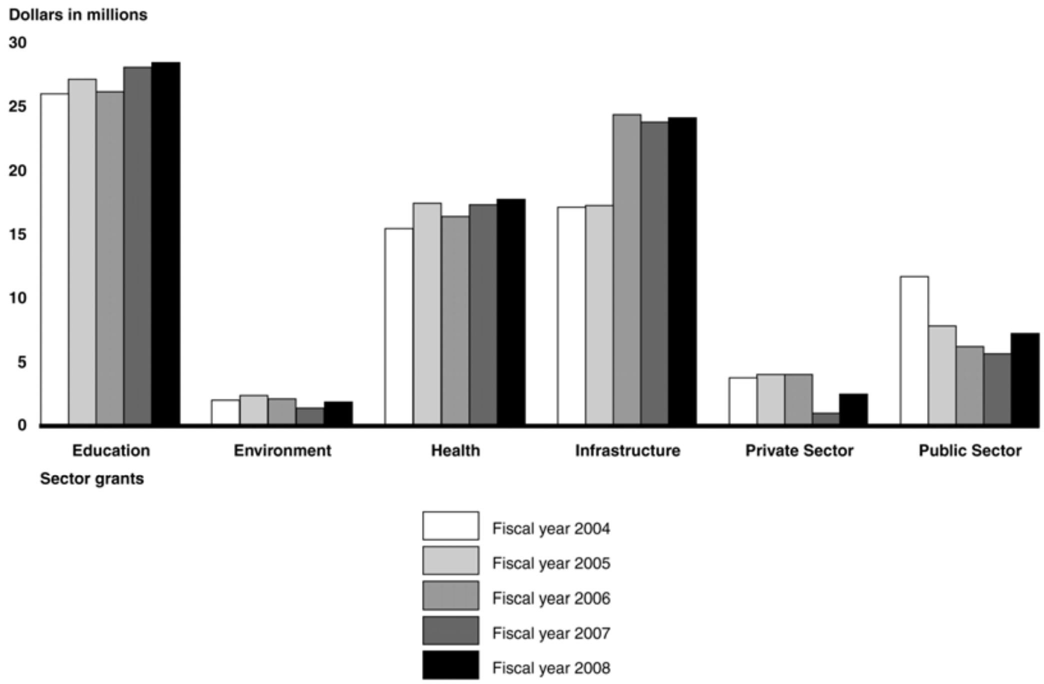
- Maintain fiscal control and accounting procedures
- Issue quarterly financial reports to be used to:
  - Monitor general budget and fiscal performance
  - Monitor sector outlays
- Meet procurement and real property requirements
- Complete financial and compliance audits
- Submit annual financial report to the United States for each sector

U.S. grant administration

- Evaluate quarterly and annual performance and financial reports to determine work progress, outcomes, and compliance with grant terms and conditions
- Use quarterly financial reports to monitor the general budget and fiscal performance of the governments, and to monitor sector grant outlays
- Make site visits as warranted
- Under certain situations, may impose special conditions or restrictions, including:
  - Make payments on a reimbursable basis
  - Require additional, more frequent, or detailed financial reporting
  - Provide for additional project monitoring
  - Require acquisition of technical or management assistance
  - Temporarily withhold cash payments or wholly or partly suspend or terminate the current award

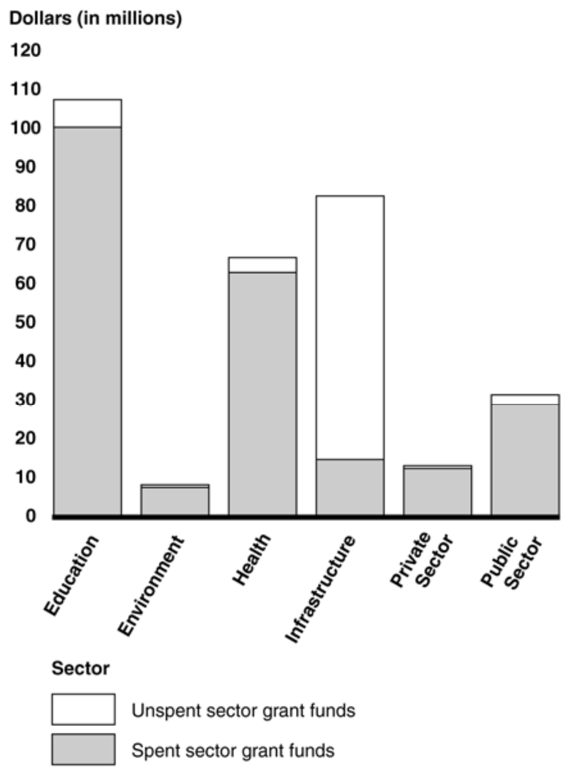
Sources: Pub. L. No. 108-188 and the subsidiary fiscal procedures agreements.

Attachment V: FSM Sector Grant Allocations, Fiscal Years 2004-2008



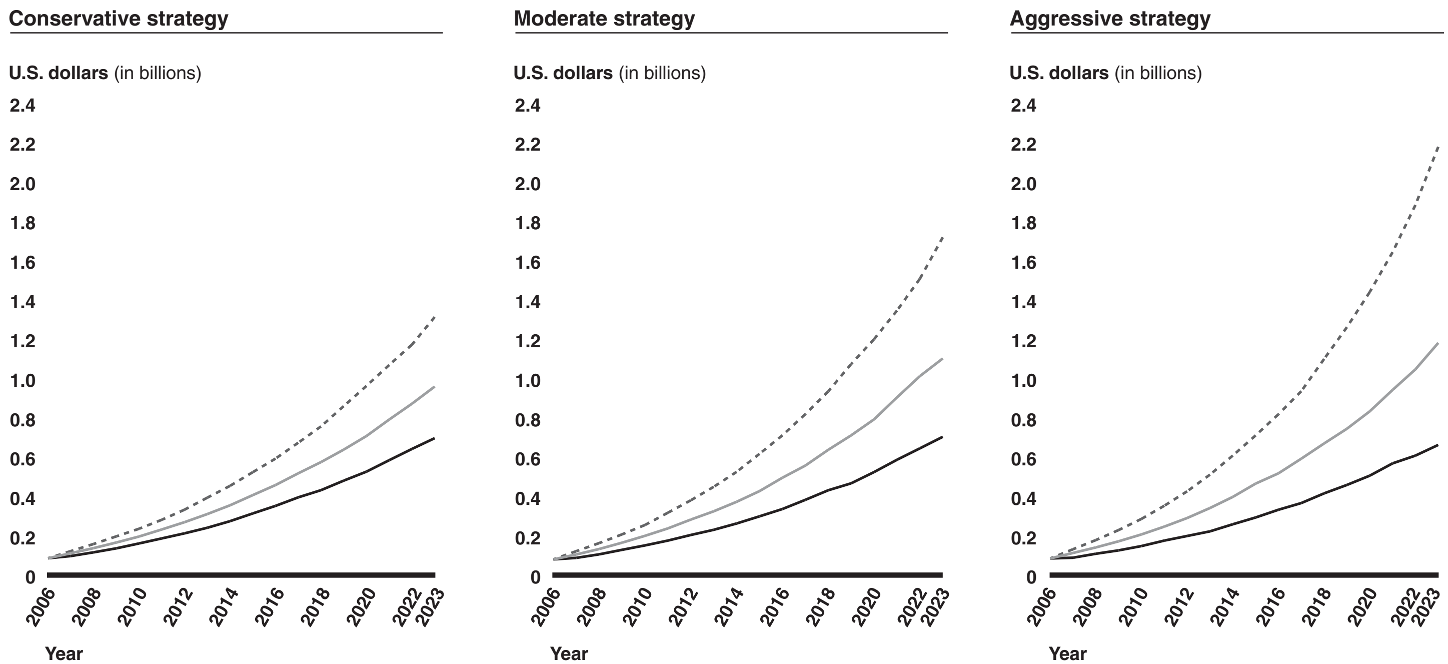
Source: GAO analysis of FSM sector grant agreement, fiscal years 2004 to 2008.

Attachment VI: FSM Unspent Compact Grants by Sector, Fiscal Years 2004 to 2007



Source: GAO analysis of Department of the Interior data.

Attachment VII: Projections of FSM Account Balance with Three Possible Investment Strategies



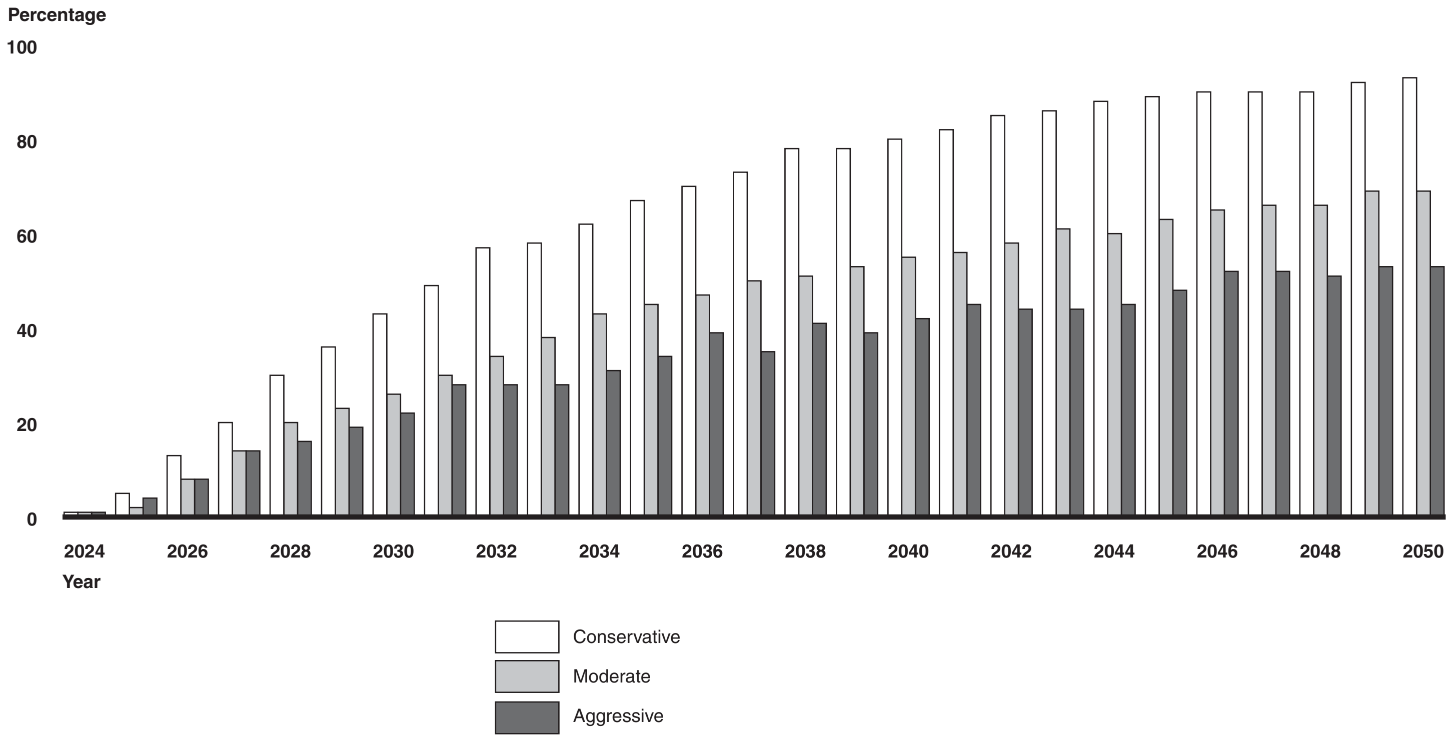
Trust fund balance in 2023

	Conservative strategy	Moderate strategy	Aggressive strategy
10th percentile	$0.697	$0.710	$0.664
Median	0.959	1.108	1.182
90th percentile	1.313	1.724	2.179

10th percentile
Median
90th percentile

Source: GAO.

Appendix VIII: Probability of FSM Trust Fund Income Not Reaching the Maximum Disbursement Levels Allowed, Fiscal Years 2024-2050



Source: GAO.

Notes: The chart depicts results from 1,000 trial runs. The change from one year to the next may not always be monotonic, but the general time trend is clear. As the number of trial runs increase, the time trend becomes smoother.