

**STATEMENT
OF
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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
REPUBLIC OF THE MARSHALL ISLANDS**

July 24, 2007

Madame Chairwoman and Members of the Committee:

I am pleased to be here today to discuss the implementation of the amended Compact of Free Association with the Republic of the Marshall Islands (RMI).

In 2003, the U.S. Government approved the amended Compact with the Republic of the Marshall Islands, providing a total of \$1.5 billion in assistance from 2004 through 2023. The amended Compact's 20 years of grant assistance is intended to assist the RMI government promote the economic advancement and budgetary self-reliance of its people. Under the amended Compact, U.S. grant funding decreases annually, paired with increasing contributions to a trust fund established for the RMI; earnings from the trust funds are intended to provide a source of revenue when the grants expire in 2023. In addition, the annual grant funding is partially adjusted for inflation. The amended Compact requires the RMI to target funding to 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 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 the grants. The amended Compact's subsidiary fiscal procedures agreement requires the RMI 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.-RMI Joint Economic Management and Financial Accountability Committee (JEMFAC) to (1) meet at least once annually to evaluate the progress of the RMI in achieving the objectives specified in the RMI's development plans; (2) approve grant allocations; (3) review required annual reports; (4) identify problems encountered; and

(5) recommend ways to increase the effectiveness of Compact grant assistance. The RMI is also required to conduct annual audits within the meaning of the Single Audit Act for an independent review of its financial position.

We believe that the amended Compact of Free Association in the Republic of the Marshall Islands is a promising work in progress. Although many challenges remain for the RMI government to grow its economy and to get better performance from the government services supported by the Compact, the RMI has been a solid partner with the United States in making the Compact work. The RMI leadership has made a determined effort to adhere both to the letter and the spirit of the agreement, and is committed to the success of the agreement it negotiated.

Since implementation of the amended Compact in FY 2004, the RMI has focused its Compact resources on the three highest priorities: infrastructure, education and health care. Over \$52.2 million, approximately 39% of all sector grant funding, has been dedicated to improved infrastructure. The result is best seen in education, where 82 new classrooms serving over 1700 students are in use, and additional classrooms that will house a total of 4000 will be in use at the end of this year. Fully one third of RMI students will be in new classrooms at the end of the 2008 school year. In upcoming years, \$5 million will be invested annually in physical improvements at the College of the Marshall Islands.

The RMI has, since FY 2004, dedicated 34% of Compact sector grant funds to education and 21% to its health care system. In addition, since 2004, the RMI has received \$18 million in Supplemental Education Grant funds to support various education activities. The RMI has chosen to use only limited amounts of Compact funding for the environment, public-sector capacity building and private-sector development sectors. The allocation reflects the priorities of the RMI government, with which the JEMFAC has concurred. The allocations may change in any future year, although allocations to the Infrastructure Sector must be at least 30% of annual Compact Assistance.

The allocation of Compact funding has been appropriate in the short term. However, growing gaps in the capacity of the RMI government suggest that it might be prudent to shift some Compact resources to public-sector capacity building. The GAO has concluded that capacity limitations have affected the RMI's ability to ensure the effective use of grant funds. We agree with this conclusion. The RMI has made strong efforts to institutionalize performance management in its government, but the RMI currently lacks the capacity to adequately measure progress because education and health sector baseline data are not adequate and performance reporting is incomplete. Capacity constraints also affect the government's ability to collect and analyze economic data and plan for the future of declining Compact revenues.

The fiscal and economic futures of the RMI are issues of concern to the United States members of the JEMFAC. A most pressing issue is an unsustainable increase in government employment and its accompanying wage bill. The RMI has reported that there has been a 23 % increase in national government employment in the past three

years. Payroll costs jumped from \$26.4 million in FY 2004 to \$30.1 million in FY 2006. This has taken place at the same time the RMI has shown annual operating deficits in its general fund. The increase in employment, again according to the RMI government, has not been accompanied by an increase in the effectiveness of government services. The ability to make this internal assessment speaks well of the RMI government, but we hope that the RMI leadership will focus on the need to manage the public payroll in a manner that accounts for the coming decrements in Compact funding.

The Compact does not operate in a vacuum, and its overall success will be greatly enhanced or diminished by the circumstances of the RMI economy. RMI has well known obstacles to economic development: its geographic location, inadequate infrastructure, lack of a skilled workforce and an out-dated business climate. The theory of the Compact is that improvements in health and education will create a better workforce at home and more remittances from abroad, and that these factors, together with improved infrastructure, will provide a foundation for private-sector economic development. Those will be long-term improvements. In the short term, we believe that there is a need for the RMI to take action to improve the business climate, including tax, land and foreign investment reforms. Although the United States, through its JEMFAC membership, may inquire about and promote change, the decisions to make these important changes lay with the Marshall Islands government.

Few factors have had as much impact on the economy of the RMI—and other Pacific states and U.S. territories—as the increased costs of fuel and the average cost per kilowatt hour of providing electricity. Fuel costs have made all imports more expensive, increased the cost of local and exported fish, and cut into household and government budgets. Utilities are strapped for cash to purchase fuel, maintain equipment, and set aside capital to invest in more efficient plants or new technology. This is a regional issue that has not spared the Marshall Islands. Although its utility, the Marshalls Energy Corporation, has a history of reliable performance, it has been unable to earn back its generating costs from electric revenues and instead subsidizes power from the sale of fuel.

An important element of the United States financial assistance under the Compact is the trust fund established to provide government revenues after annual sector grants cease after 2023.

As of March 31, 2007, the market value of total assets of the Trust Fund for the People of the Republic of the Marshall Islands was \$78.2 million. Of that amount, \$64.3 million represented contributions of governments, including \$31.8 million from the United States, \$30 million from the RMI, and \$2.5 million from Taiwan. The return on assets during the fiscal year ending September 30, 2006 was 11.8 percent

Since Goldman Sachs began managing the Trust Fund assets as investment manager on November 14, 2005, the Fund's investments have gained \$9.6 million through March 31, 2007 and \$13.2 million through May 31, 2007. The assets have been invested in a mix of U.S. public equity and realty funds, international equity funds, and fixed income funds.

The Trust Fund Committee is also investigating securitization of the future U.S. contributions to the Trust Fund as a means of increase the return, and has approved the drafting of an RFP for 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 U.S. contributions scheduled for later years. A change in the Compact law may be necessary in order to implement a securitization program. At this point the Administration has not taken a position on the merits or advisability of securitizing future contributions to the Trust Fund.

The next formal meeting of the JEMFAC takes place in late August. In addition to allocating the resources of the six sector grants, the committee will discuss the RMI's progress in implementing tax and fiscal reform, work with the RMI to establish plans to minimize the impact of declining assistance, and work with the RMI to better measure progress toward Compact and sector grant goals.

In summary, the Republic of the Marshalls Islands faces very serious challenges, but we are pleased with the manner in which we are working together to try to address those challenges through the implementation of the Compact. Representatives of my office were in Majuro last week consulting on the sector grant proposals that will be presented to the annual meeting of JEMFAC. They report that their discussions with the RMI were friendly and useful, and that the RMI government representatives were prepared and thoughtful as they presented their FY 2008 plans. My staff believes that it will be able to recommend that JEMFAC adopt the proposals as submitted by the RMI government. The Compact is working, not without bumps and major challenges, but with mutual respect and the mutual hard work of both countries.

Madame Chairwoman and Members of the subcommittee, this completes my prepared statement. I will be happy to respond to any questions you may have at this time.