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COMPACT OF FREE ASSOCIATION

Implementation Activities Have Progressed, but the Marshall Islands Faces Challenges to Achieving Long-Term Compact Goals

Statement of David B. Gootnick, Director
International Affairs and Trade





Highlights of [GAO-07-1125T](#), a testimony to the Subcommittee on Asia, the Pacific, and the Global Environment, Committee on Foreign Affairs, House of Representatives

Why GAO Did This Study

In 2003, the U.S. government extended its economic assistance to the Republic of the Marshall Islands (RMI) through an Amended Compact of Free Association. From 2004 to 2023, the United States will provide an estimated \$1.5 billion to the RMI, with annually decreasing grants as well as increasing contributions to a trust fund. The assistance, targeting six sectors, is aimed at assisting the country's efforts to promote economic advancement and budgetary self-reliance. The trust fund is to be invested and provide income for the RMI after compact grants end. The Department of the Interior (Interior) administers and oversees this assistance. Drawing on prior GAO reports ([GAO-05-633](#), [GAO-06-590](#), [GAO-07-163](#), [GAO-07-513](#), [GAO-07-514R](#)), this testimony discusses (1) the RMI's economic prospects, (2) implementation of the amended compact to meet long-term goals, and (3) potential trust fund earnings. In conducting its prior work, GAO visited the RMI, reviewed reports, interviewed officials and experts, and used a simulation model to project the trust fund's income.

Prior GAO reports recommended, among other things, that Interior work with the RMI to address lack of progress in implementing reforms; plan for declining grants; reliably measure progress; and ensure timely reporting on the fund's likely status as a source of revenue after 2023. Interior agreed with GAO's recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-07-1125T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David Gootnick, (202) 512-3149, gootnick@gao.gov.

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Implementation Activities Have Progressed, but the Marshall Islands Faces Challenges to Achieving Long-term Compact Goals

What GAO Found

The RMI has limited prospects for achieving its long-term development goals and has not enacted policy reforms needed to achieve economic growth. The RMI economy depends on public sector spending of foreign assistance rather than on private sector or remittance income. At the same time, the two private sector industries identified as having growth potential—fisheries and tourism—face significant barriers to expansion because of a costly business environment. RMI emigrants also lack marketable skills needed to increase revenue from remittances. Despite declining grants under the compact, RMI progress in implementing key policy reforms to improve the private sector environment, such as tax or land reform, has been slow. In August 2006, the RMI's compact management committee began to address the country's slow progress in implementing reforms.

Although the RMI has made progress in implementing compact assistance, it faces several challenges in allocating and using this assistance to support its long-term development goals. RMI grant allocations have reflected compact priorities by targeting health, education, and infrastructure. However, political disagreement over land use and management of public entities has negatively affected infrastructure projects. The RMI also has not planned for long-term sustainability of services that takes into account declining compact assistance. Inadequate baseline data and incomplete performance reports have further limited the RMI's ability to adequately measure progress. Although single-audit reporting has been timely, insufficient staff and skills have limited the RMI's ability to monitor day-to-day sector grant operations. Interior's Office of Insular Affairs (OIA) has conducted administrative oversight of the sector grants but has been constrained by competing oversight priorities.

The RMI trust fund may not provide sustainable income for the country after compact grants end. Market volatility and the choice of investment strategy could cause the RMI trust fund balance to vary widely, and there is increasing probability that in some years the trust fund will not reach the maximum disbursement level allowed—an amount equal to the inflation-adjusted compact grants in 2023—or be able to disburse any income. In addition, although the RMI has supplemented its trust fund income with a contribution from Taiwan, other sources of income are uncertain or entail risk. Trust fund management processes have also been problematic; as of June 2007, the RMI trust fund committee had not appointed an independent auditor or a money manager to invest the fund according to the proposed investment strategy.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss GAO's recent work regarding the Compact of Free Association between the United States and the Republic of the Marshall Islands (RMI). From 1987 through 2003,¹ the United States provided more than \$2 billion in economic assistance to the Federated States of Micronesia (FSM) and the RMI under a Compact of Free Association;² approximately \$579 million of this economic assistance went to the RMI. In 2003, the U.S. government approved an amended compact with the RMI that provides an additional 20 years of assistance, totaling about \$1.5 billion from 2004 through 2023.³ The Department of the Interior's Office of Insular Affairs (OIA) is responsible for administering and monitoring this U.S. assistance.

The amended compact with the RMI identifies the additional 20 years of grant assistance as intended to assist the RMI government 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 trust funds intended as a source of revenue for the country after the grants end in 2023. The amended compact also contains several new funding and accountability provisions that strengthen reporting and bilateral interaction. These provisions include requiring the establishment of a joint economic management committee and a trust fund committee to, respectively, among other things, review the RMI's progress toward compact objectives and to assess the trust fund's effectiveness in contributing to the country's long-term economic advancement and budgetary self-reliance. In 2003, we testified that these provisions could improve accountability over assistance but that successful implementation

¹In this testimony, all annual references refer to the fiscal year rather than the calendar year.

²In 2000, we reviewed assistance under the compact and determined that the U.S. and RMI governments had provided limited accountability over spending and that U.S. assistance had resulted in little impact on economic development in the RMI. See GAO, *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).

³This figure is based on a Department of Interior projection as of July, 2007.

will require appropriate resources and sustained commitment from both the United States and the RMI.⁴

Today, drawing on several reports that we have published since 2005,⁵ I will discuss the RMI's economic prospects, implementation of the amended compact to meet its long-term goals, and potential trust fund earnings.

Summary

The RMI has limited prospects for achieving its long-term development objectives and has not enacted policy reforms needed to enable economic growth. The RMI depends on public sector spending of foreign assistance rather than on private sector or remittance income; public sector expenditure accounts for more than half of its gross domestic product (GDP). The RMI government budget largely depends on foreign assistance and, despite annual decrements in compact funding to support budgetary expenditures, is characterized by a growing wage bill. Meanwhile, the two private sector industries identified as having growth potential—fisheries and tourism—face significant barriers to expansion because of the RMI's remote geographic location, inadequate infrastructure, and poor business environment. In addition, RMI emigrants lack marketable skills that are needed to increased revenue from remittances. Moreover, progress in implementing key policy reforms necessary to improve the private sector environment has been slow. For example, although economic experts describe the RMI's current tax system as complex and regressive, the RMI

⁴GAO, *Compact of Free Association: An Assessment of the Amended Compacts and Related Agreements*, [GAO-03-988T](#) (Washington, D.C.: June 18, 2003), testimony before the Committee on Resources, House of Representatives.

⁵The amended compacts' implementing legislation instructs GAO to report 3 years following the enactment of the legislation and every 5 years thereafter on the RMI's use and effectiveness of U.S. financial, program, and technical assistance as well as the effectiveness of administrative oversight by the United States. See GAO, *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); GAO, *Compacts of Free Association: Development Prospects Remain Limited for the Micronesia and the Marshall Islands*, [GAO-06-590](#) (Washington, D.C.: June 27, 2006); GAO, *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); GAO, *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); and GAO, *Compact of Free Association: Micronesia and the Marshall Island's Use of Sector Grants*, [GAO-07-514R](#) (Washington, D.C.: May 25, 2007).

government has not implemented fundamental tax reform. Further, although the RMI has established land registration offices, continued uncertainties over land ownership and land values hamper the use of land as an asset. Foreign investment regulations remain burdensome, and RMI government involvement in commercial activities continues to hinder private sector development. Moreover, at the time of our 2006 report, the RMI's compact management committee had not addressed the country's slow progress in implementing reforms.

The RMI has made progress in implementing compact assistance, but it faces several challenges in allocating and using this assistance to support its long-term development goals. RMI grant allocations have reflected compact priorities by targeting health, education, and infrastructure—for example, funding construction of nine new schools. However, in the case of Kwajalein Atoll, political disagreement over management of public entities and government use of leased land has negatively affected the construction of schools and the use of compact funds set aside for Ebeye special needs.⁶ The RMI also has not planned for long-term sustainability of services that takes into account the annual funding decrement. Capacity limitations have further affected its ability to ensure the effective use of grant funds. The RMI currently lacks the capacity to adequately measure progress, owing to inadequate baseline data and incomplete performance reports. Moreover, although accountability—as measured by timeliness in single audit reporting and corrective action plans to single audit findings—has improved, insufficient staff and skills have limited the RMI's ability to monitor day-to-day sector grant operations as the compacts require. Inadequate communication about grant implementation may further hinder the U.S. and RMI governments from ensuring the grants' effective use. Although Interior's Office of Insular Affairs (OIA) has conducted administrative oversight of the sector grants, its oversight has similarly been constrained by staffing challenges and the need to assist the FSM with its compact implementation activities.

The RMI trust fund may not provide sustainable income for the country after compact grants end, potential sources for supplementing trust fund income have limitations, and the trust fund committee has experienced management challenges. Market volatility and the choice of investment

⁶Kwajalein Atoll is the RMI's second most populated atoll, where many residents were displaced to provide space for U.S. missile testing. Many of these residents now reside on Ebeye Island.

strategy could cause the RMI trust fund balance to vary widely, and there is increasing probability that in some years the trust fund will not reach the maximum disbursement level allowed—an amount equal to the inflation-adjusted compact grants in 2023—or be able to disburse any income. The trust fund committee’s reporting has not analyzed the fund’s potential effectiveness in helping the RMI achieve its long-term economic goals. Although the RMI has supplemented its trust fund income with a contribution from Taiwan, other sources of income are uncertain or entail risk. For example, the RMI’s limited development prospects constrain its ability to raise tax revenues to supplement the fund’s income, and options such as securitization—issuing bonds against future U.S. contributions—include the risk of lower fund balances and reduced income. Furthermore, according to U.S. government officials, trust fund management processes have been problematic. As of June 2007, for example, the RMI trust fund committee had not appointed an independent auditor or a money manager to invest the fund according to the proposed investment strategy.

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 address the RMI’s lack of progress in implementing economic reforms; work with the RMI to develop plans for minimizing the impact of the declining grants; work with the RMI 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.

Background

Compact of Free Association: 1986-2003

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

Although the first and second goals of the original compact were met, economic self-sufficiency was not achieved under the first compact. The FSM and the RMI became independent nations in 1978 and 1979, respectively, and the three countries established key defense rights, including securing U.S. access to military facilities on Kwajalein Atoll in the RMI through 2016. The compact's third goal was to be accomplished primarily through U.S. direct financial assistance to the FSM and the RMI that totaled \$2.1 billion from 1987 through 2003.⁷ However, estimated FSM and RMI per capita GDP levels at the close of the compact did not exceed, in real terms, those in the early 1990s,⁸ although U.S. assistance had maintained income levels that were higher than the two countries could have achieved without support. In addition, we found that the U.S., FSM, and RMI governments provided little accountability over compact expenditures and that many compact-funded projects experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds.⁹

Amended Compacts of Free Association: 2004-2023

In 2003, the United States approved separate amended compacts with the FSM and RMI that (1) continue the defense relationship, including a new agreement providing U.S. military access to Kwajalein Atoll in the RMI through 2086; (2) strengthen immigration provisions; and (3) provide an estimated \$3.6 billion in financial assistance to both nations from 2004 through 2023, including about \$1.5 billion to the RMI (see app. I).¹⁰ The amended compacts identify the additional 20 years of grant assistance as intended to assist the FSM and RMI governments in their efforts to promote the economic advancement and budgetary self-reliance of their people. Financial assistance is provided in the form of annual sector grants and contributions to each nation's trust fund. The amended

⁷This estimate is based on Interior data and represents total nominal outlays. It does not include payments for compact-authorized federal services or U.S. military use of Kwajalein Atoll land, nor does it include investment development funds provided under section 111 of Public Law 99-239.

⁸Estimated FSM per capita GDP, in fiscal year 2003 U.S. dollars, was \$2,151 in 2003 compared with an average of \$2,093 from 1990 to 1995. Estimated RMI per capita GDP, in fiscal year 2003 U.S. dollars, was \$2,247 in 2003 compared with an average of \$2,336 from 1990 to 1995.

⁹[GAO/NSIAD-00-216](#).

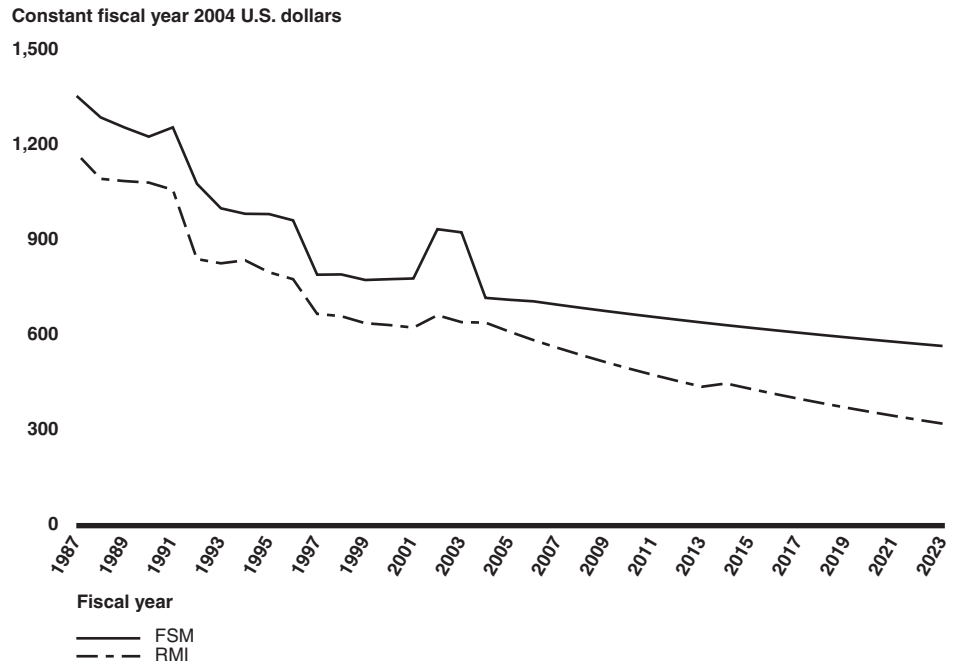
¹⁰The RMI and FSM amended compacts went into effect on May 1, 2004, and June 25, 2004, respectively. The \$1.5 billion in assistance to the RMI includes (1) compact grants; (2) trust fund contributions; (3) lease payments; and (5) inflation adjustments.

compacts and their subsidiary agreements, along with the countries' development plans, target the grant assistance to six sectors—education, health, public infrastructure, the environment, public sector capacity building, and private sector development—prioritizing two sectors, education and health.¹¹ To provide increasing U.S. contributions to the FSM's and the RMI's trust funds, 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 fig. 1).¹² For example, in 2004 U.S. dollar terms, FSM per capita grant assistance will fall from around \$1,352 in 1987 to around \$562 in 2023, and RMI per capita assistance will fall from around \$1,170 in 1987 to around \$317 in 2023.

¹¹The RMI compact requires its infrastructure grant to be 30 to 50 percent of its total annual sector grants. Additionally, the RMI must target grant funding to Ebeye and other Marshallese communities within Kwajalein Atoll.

¹²U.S. contributions to trust funds were conditioned on the FSM and the RMI making their own required contribution. The RMI made its required initial contribution of \$30 million to its trust fund on June 1, 2004.

Figure 1: Estimated FSM and RMI Per Capita Compact Grant Assistance for Fiscal Years 1987-2023



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

Note: Compact grant assistance was 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) is decreased annually. U.S. contributions to each country's trust funds increase by the same amount as the grant decrement. Funding for compact-authorized federal services, trust-fund contributions, and U.S. military use of Kwajalein Atoll land is not included.

Under the amended compacts, annual grant assistance is to be made available in accordance with an implementation framework that has several components (see app. II). For example, prior to the annual awarding of compact funds, the countries must submit development plans that identify goals and performance objectives for each sector. The FSM and RMI governments are also required to monitor day-to-day operations of sector grants and activities, submit periodic financial 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 FSM Joint Economic Management Committee (JEMCO) and the U.S. and RMI Joint Economic Management and Financial Accountability Committee (JEMFAC) are to approve annual sector grants and evaluate the countries' management of the grants and their progress toward compact goals. The amended compacts also provide for the formation of FSM and RMI trust

fund committees to, among other things, hire money managers, oversee the respective funds' operation and investment, and provide annual reports on the effectiveness of the funds.

Current Development Prospects Remain Limited for the RMI

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

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

- Since 2000, the estimated public sector share of GDP has grown, with public sector expenditure in 2005—about two-thirds of which is funded by external grants—accounting for about 60 percent of GDP.
- The RMI's government budget is characterized by limited tax revenue paired with growing government payrolls. For example, RMI taxes have consistently provided less than 30 percent of total government revenue; however, payroll expenditures have roughly doubled, from around \$17 million in 2000 to around \$30 million in 2005.
- The RMI development plan identifies fishing and tourism as key potential private sector growth industries. However, the two industries combined currently provide less than 5 percent of employment, and both industries face significant constraints to growth that stem from structural barriers and a costly business environment. According to economic experts, growth in these industries is limited by factors such as geographic isolation, lack of tourism infrastructure, inadequate interisland shipping, a limited pool of skilled labor, and a growing threat of overfishing.
- Although remittances from emigrants could provide increasing monetary support to the RMI, evidence suggests that RMI emigrants are currently limited in their income-earning opportunities abroad owing to inadequate education and vocational skills. For example, the 2003 U.S. census of RMI migrants in Hawaii, Guam, and the Commonwealth of the Northern Marianas Islands reveals that only 7 percent of those 25 years and older had a college degree and almost half of RMI emigrants lived below the poverty line.¹³

¹³See [GAO-06-590](#). However, a preliminary survey of RMI emigrants in Springdale, Arkansas suggests that the emigrant population there has higher education levels and lower poverty levels relative to the emigrant population in Hawaii, Guam, and the CNMI.

Although the RMI has undertaken efforts aimed at economic policy reform,¹⁴ it has made limited progress in implementing key tax, land, foreign investment, and public sector reforms that are needed to improve its growth prospects. For example:

- The RMI government and economic experts have recognized for several years that the RMI tax system is complex and regressive, taxing on a gross rather than net basis and having weak collection and administrative capacity. Although the RMI has focused on improving tax administration and has raised some penalties and tax levels, legislation for income tax reform has failed and needed changes in government import tax exemptions have not been addressed.
- In attempts to modernize a complex land tenure system, the RMI has established land registration offices. However, such offices have lacked a systematic method for registering parcels, instead waiting for landowners to voluntarily initiate the process. For example, only five parcels of land in the RMI had been, or were currently being, registered as of June 2006. Continued uncertainties over land ownership and land values create costly disputes, disincentives for investment, and problems regarding the use of land as an asset.
- Economic experts and private sector representatives describe the overall climate for foreign investment in the RMI 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.
- The RMI government has endorsed public sector reform; however, efforts to reduce public sector employment have generally failed, and the government continues to conduct a wide array of commercial enterprises that require subsidies and compete with private enterprises. As of June 2006, the RMI had not prepared a comprehensive policy for public sector enterprise reform.

Although the RMI development plan includes objectives for economic reform, until August 2006—two years into the amended compact—JEMFAC did not address the country’s slow progress in implementing these reforms.

¹⁴For example, the Asian Development Bank has recently assisted the RMI in holding “Dialogue for Action” retreats that enable public and private sector representatives to develop a common vision for sustainable development through economic reform.

The RMI Faces Challenges to Effectively Implementing Compact Assistance for Its Long-Term Development Goals

The RMI has allocated funds to priority sectors, although several factors have hindered its use of the funds to meet long-term development needs. Further, despite actions taken to effectively implement compact grants, administrative challenges have limited its ability to ensure use of the grants for its long-term goals. In addition, although OIA has monitored early compact activities, it has also faced capacity constraints.

The RMI allocated compact funds largely to priority sectors for 2004-2006. The RMI allocated about 33 percent, 40 percent, and 20 percent of funds to education, infrastructure, and health, respectively (see fig. 2). The education allocation included funding for nine new school construction projects, initiated in October 2003 through July 2006. However, various factors, such as land use issues and inadequate needs assessments, have limited the government's use of compact funds to meet long-term development needs. For example:

- *Management and land use issues.* The RMI government and Kwajalein landowners have been disputing the management of public entities and government use of leased land on the atoll. Such tensions have negatively affected the construction of schools and other community development initiatives.¹⁵ For example, the government and landowners disagreed about the management of the entity designated to use the compact funds set aside for Ebeye special needs; consequently, about \$3.3 million of the \$5.8 million allocated for this purpose had not been released for the community's benefit until after September 2006.¹⁶ In addition, although the RMI has completed some infrastructure projects where land titles were clear and long-term leases were available, continuing uncertainty regarding land titles may delay future projects.
- *Lack of planning for declining U.S. assistance.* Despite the goal of budgetary self-reliance, the RMI lacks concrete plans for addressing the

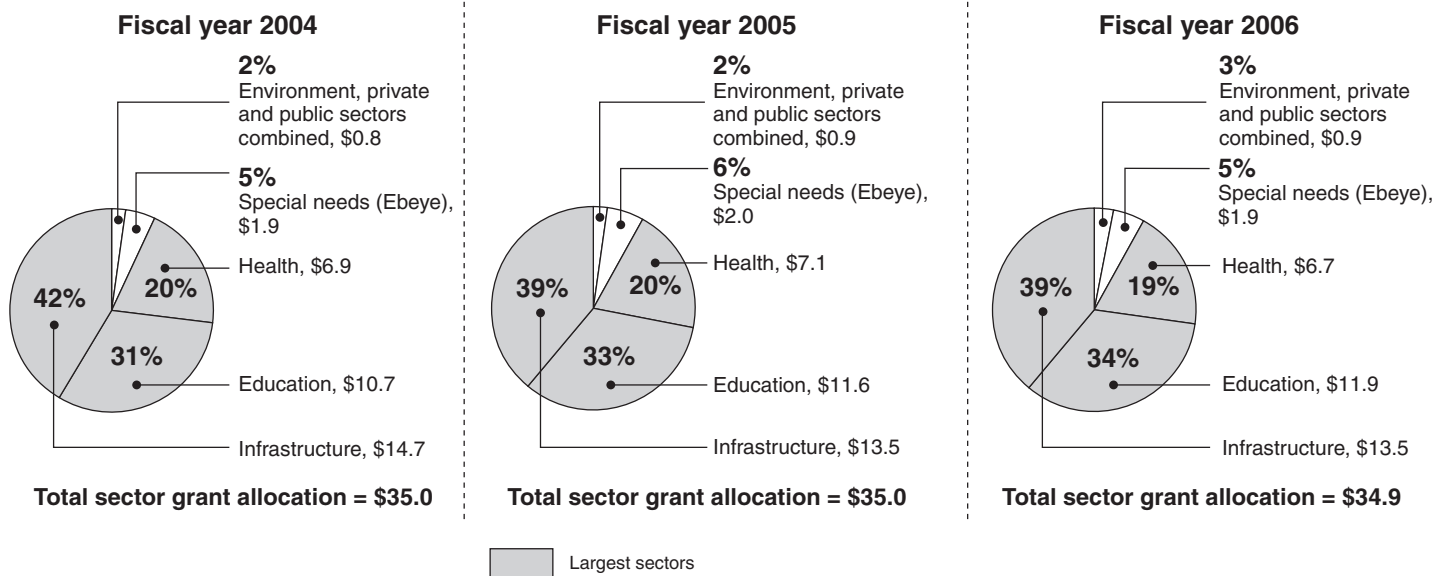
¹⁵In addition to these examples, land issues remain an issue for U.S. access to Kwajalein Atoll through the defense provisions of the amended compact. The RMI government is bound by an agreement with the U.S. government that allows for U.S. access to Kwajalein Atoll until 2086. To date, the RMI government has not reached an agreement with Kwajalein Atoll landowners (who own the land under use by the U.S. government) that allows for this long-term access.

¹⁶The funds were supposed to be allocated to the Kwajalein Atoll Development Authority, which experienced problems in effectively and efficiently using funds in the past. In early 2005, RMI legislation stipulated the authority's restructuring; however, the law was subsequently repealed by the RMI government. Kwajalein landowners are challenging this decision in court.

annual decrement in compact funding, which could limit its ability to sustain current levels of government services in the future. RMI officials told us that they can compensate for the decrement in various ways, such as through the yearly partial adjustment for inflation provided for in the amended compacts or through improved tax collection. However, the partial nature of the adjustment causes the value of the grant to fall in real terms, independent of the decrement, thereby reducing the government's ability to pay over time for imports, such as energy, pharmaceutical products, and medical equipment. Additionally, the RMI's slow progress in implementing tax reform will limit its ability to augment tax revenues.

Figure 2: RMI Sector Grant Allocation, 2004-2006

Dollars in millions



Source: GAO analysis of RMI fiscal years 2004 through 2006 sector grant agreements.

Note: Supplemental Education Grant funds, which started in 2005, are not depicted. In cases where funds were unspent and deobligated in one year and reobligated in a subsequent year, we included the funds only in the year in which they were initially obligated. In 2006, the special needs grant to Ebeye for the first time consolidated amounts provided to Ebeye across the other sectors. In this figure, these amounts are included in the other sector allocations for consistency.

The RMI has taken steps to effectively implement compact assistance, but administrative challenges have hindered its ability to ensure use of the funds for its long-term development goals. The RMI established

development plans that include strategic goals and objectives for the sectors receiving compact funds.¹⁷ Further, in addition to establishing JEMFAC, the RMI designated the Ministry of Foreign Affairs as its official contact point for compact policy and grant implementation issues.¹⁸ However, data deficiencies, report shortcomings, capacity constraints, and inadequate communication have limited the RMI and U.S. governments' ability to consistently ensure the effective use of grant funds to measure progress, and monitor day-to-day activities.

- *Data deficiencies.* Although the RMI established performance measurement indicators, a lack of complete and reliable data has prevented the use of these indicators to assess progress. For example, the RMI submitted data to JEMFAC for only 15 of the 20 required education performance indicators in 2005, repeating the submission in 2006 without updating the data. Also, in 2005, the RMI government reported difficulty in comparing the health ministry's 2004 and 2005 performance owing to gaps in reported data—for instance, limited data were available in 2004 for the outer island health care system.
- *Report shortcomings.* The usefulness of the RMI's quarterly performance reports has also been limited by incomplete and inaccurate information. For example, the RMI Ministry of Health's 2005 fourth-quarter report contained incorrect outpatient numbers for the first three quarters, according to a hospital administrator. Additionally, we found several errors in basic statistics in the RMI quarterly reports for education, and RMI Ministry of Education officials and officials in other sectors told us that they had not been given the opportunity to review the final performance reports compiled by the statistics office prior to submission.
- *Capacity constraints.* Staff and skill limitations have constrained the RMI's ability to provide day-to-day monitoring of sector grant operations. However, the RMI has submitted its single audits on time. In addition, although the single audit reports for 2004 and 2005

¹⁷The RMI's development plan consists of three documents: Vision 2018, Meto 2000, and the Medium Term Budget and Investment Framework. In addition, the annual portfolio submissions include strategic goals and indicators for each of the sectors. We refer collectively to all of these RMI documents as "the development plan."

¹⁸Prior to designating the Ministry of Foreign Affairs as a compact implementation unit, the RMI had identified the Office of the Chief Secretary as the official point of contact for all communication and correspondence with the U.S. government concerning compact sector grant assistance. The RMI's Economic Policy, Planning, and Statistics Office also works with the ministries receiving grants to prepare the annual budget proposals, quarterly reports, and annual monitoring and evaluation reports.

indicated weaknesses in the RMI's financial statements and compliance with requirements of major federal programs, the government has developed corrective action plans to address the 2005 findings related to such compliance.

- *Lack of communication.* Our interviews with U.S. and RMI department officials, private sector representatives, NGOs, and economic experts revealed a lack of communication and dissemination of information by the U.S. and RMI governments on issues such as JEMFAC decisions, departmental budgets, economic reforms, legislative decisions, and fiscal positions of public enterprises. Such lack of information about government activities creates uncertainty for public, private, and community leaders, which can inhibit grant performance and improvement of social and economic conditions.

As administrator of the amended compact grants, OIA monitored sector grant and fiscal performance, assessed RMI compliance with compact conditions, and took action to correct persistent shortcomings. For example, since 2004, OIA has provided technical advice and assistance to help the RMI improve the quality of its financial statements and develop controls to resolve audit findings and prevent recurrences. However, OIA has been constrained in its oversight role owing to staffing challenges and time-consuming demands associated with early compact implementation challenges in the FSM.

RMI Trust Fund May Not Provide Sustainable Income After Compact Grants End

Market volatility and choice of investment strategy could lead to a wide range of RMI trust fund balances in 2023 (see app. III) and potentially prevent trust fund disbursements in some years. Although the RMI has supplemented its trust fund balance with additional contributions, other sources of income are uncertain or entail risks. Furthermore, the RMI's trust fund committee has faced challenges in effectively managing the fund's investment.

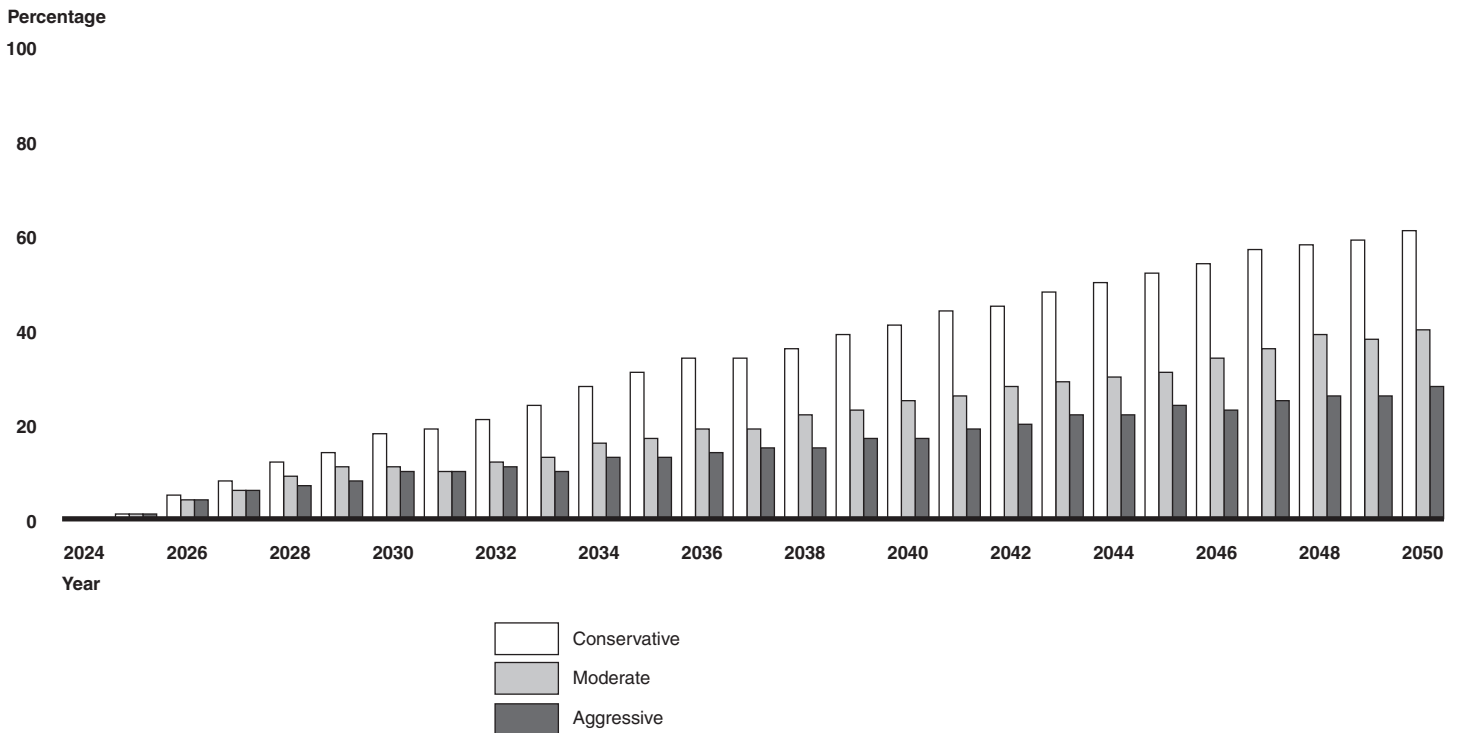
Market volatility and investment strategy could have a considerable impact on projected trust fund balances in 2023. Our analysis indicates that, under various scenarios, the RMI's trust fund could fall short of the maximum allowed disbursement level¹⁹—an amount equal to the inflation-adjusted compact grants in 2023—after compact grants end, with the

¹⁹The trust fund agreements specify that in 2024 and thereafter, the RMI trust fund committee may disburse amounts up to the annual grant assistance in 2023, fully adjusted for inflation, provided that funds are available in the B account to reach such a level.

probability of shortfalls increasing over time (see fig. 3).²⁰ For example, under a moderate investment strategy, the fund's income is only around 10 percent likely to fall short of the maximum distribution by 2031. However, this probability rises to almost 40 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 10 percent by 2050. Despite the impact of market volatility and investment strategy, the trust fund committee's reports have not yet assessed the fund's potential adequacy for meeting the RMI's long-term economic goals.

²⁰Our methodology for projecting trust fund income is based 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 funds' 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](#).

Figure 3: Probability of RMI Trust Fund Income Not Reaching the Maximum Disbursement Allowed, Fiscal Years 2024-2050



Source: GAO.

Notes: Our analysis of the RMI's trust fund includes Taiwan's contribution. 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.

RMI trust fund income could be supplemented from several sources, although this potential is uncertain. For example, the RMI received a commitment from Taiwan to contribute \$40 million over 20 years to the RMI trust fund, which improved the RMI fund's likely capacity for disbursements after 2023. However, the RMI's limited development prospects constrain its ability to raise tax revenues to supplement the fund's income. 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.²¹

The RMI trust fund committee has experienced management challenges in establishing the trust fund to maximize earnings. Contributions to the trust fund were initially placed in a low-interest savings account and were not invested until 16 months after the initial contribution.²² As of June 2007, the RMI trust fund committee had not appointed an independent auditor or a money manager to invest the fund according to the proposed investment strategy. U.S. government officials suggested that contractual delays and committee processes for reaching consensus and obtaining administrative support contributed to the time taken to establish and invest funds. As of May 2007, the committee had not yet taken steps to improve these processes.

Conclusions

Since enactment of the amended compacts, the U.S. and RMI governments have made efforts to meet new requirements for implementation, performance measurement, and oversight. However, the RMI faces significant challenges in working toward the compact goals of economic advancement and budgetary self-reliance as the compact grants decrease. Largely dependent on government spending of foreign aid, the RMI has limited potential for private sector growth, and its government has made little progress in implementing reforms needed to increase investment opportunities and tax income. In addition, JEMFAC did not address the pace of reform during the first 2 years of compact implementation. Further, both the U.S. and RMI governments have faced significant capacity constraints in ensuring effective implementation of grant funding. The RMI government and JEMFAC have also shown limited commitment to strategically planning for the long-term, effective use of grant assistance or for the budgetary pressure the government will face as compact grants decline. Because the trust fund's earnings are intended as a main source of U.S. assistance to the RMI after compact grants end, the fund's potential inadequacy to provide sustainable income in some years could impact the

²¹According to Interior officials, the trust fund committees are reviewing this option but have not initiated an independent study to objectively evaluate its potential risks.

²²For the months before the investment of the RMI trust fund's approximately \$49 million in October 2005, the fund earned a return of approximately 3 percent, compared with a stock market return of about 4 percent. Given the small difference in returns, as well as the fees that the fund would have paid if invested in the stock market, we estimate that this delay reduced the fund's earnings by approximately \$51,000.

RMI's ability to provide government services. However, the RMI trust fund committee has not assessed the potential status of the fund as an ongoing source of revenue after compact grants end in 2023.

Prior Recommendations

Our prior reports on the amended compacts²³ include recommendations that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as chair of the RMI management and trust fund committees, to, among other things,

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

Interior generally concurred with our recommendations and has taken actions in response to several of them. For example, in August 2006, JEMFAC discussed the RMI's slow progress in implementing economic reforms. Additionally, the trust fund committee decided in June 2007 to create a position for handling the administrative duties of the fund. Regarding planning for declining assistance and measuring progress toward compact goals, JEMFAC has not held an annual meeting since the December 2006 publication of the report containing those recommendations.²⁴

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.

²³GAO-05-633, GAO-06-590, GAO-07-163, GAO-07-513, GAO-07-514R.

²⁴GAO-07-163, p. 50.

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., Ming Chen, Tracy Guerrero, Julie Hirshen, Leslie Holen, Reid Lowe, Mary Moutsos, Kendall Schaefer, and Eddie Uyekawa.

Appendix I: U.S. Assistance to Be Provided to the FSM and the RMI under the Amended Compacts, 2004-2023

(Dollars in millions)

Fiscal year	FSM grants (Section 211)	FSM trust fund (Section 215)	RMI grants (Section 211)	RMI trust fund (Section 216)	Kwajalein Impact (Section 212)a
2004	\$76.2	\$16.0	\$35.2	\$7.0	\$15.0
2005	76.2	16.0	34.7	7.5	15.0
2006	76.2	16.0	34.2	8.0	15.0
2007	75.4	16.8	33.7	8.5	15.0
2008	74.6	17.6	33.2	9.0	15.0
2009	73.8	18.4	32.7	9.5	15.0
2010	73.0	19.2	32.2	10.0	15.0
2011	72.2	20.0	31.7	10.5	15.0
2012	71.4	20.8	31.2	11.0	15.0
2013	70.6	21.6	30.7	11.5	15.0
2014	69.8	22.4	32.2	12.0	18.0
2015	69.0	23.2	31.7	12.5	18.0
2016	68.2	24.0	31.2	13.0	18.0
2017	67.4	24.8	30.7	13.5	18.0
2018	66.6	25.6	30.2	14.0	18.0
2019	65.8	26.4	29.7	14.5	18.0
2020	65.0	27.2	29.2	15.0	18.0
2021	64.2	28.0	28.7	15.5	18.0
2022	63.4	28.8	28.2	16.0	18.0
2023	62.6	29.6	27.7	16.5	18.0

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

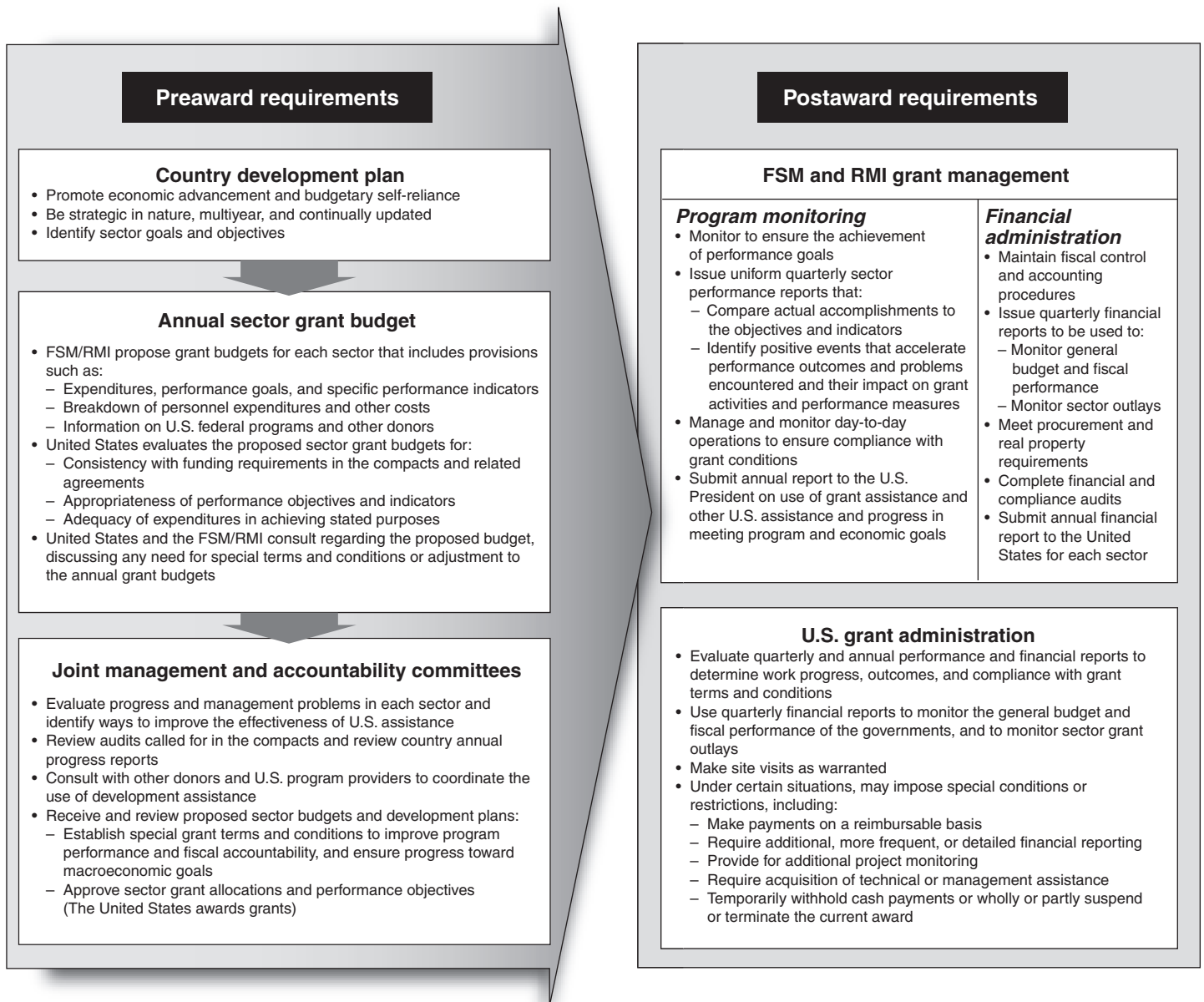
Notes:

For both the FSM and the RMI, 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, that will be provided to both countries.

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.

^a“Kwajalein Impact” funding is provided to the RMI government, which in turn compensates Kwajalein Atoll landowners for U.S. access to the atoll for military purposes.

Appendix II: Amended Compact Implementation Framework



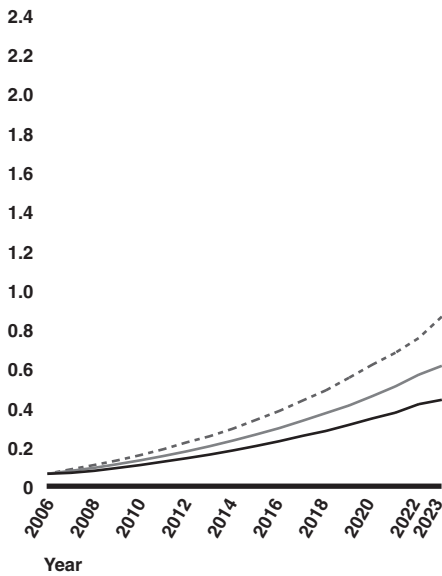
Sources: Pub. L. No. 108-188 and the subsidiary fiscal procedures agreements.

Note: This figure does not list all of the compact or fiscal procedures agreements requirements

Appendix III: Projections of RMI Account Balance with Three Possible Investment Strategies

Conservative strategy

U.S. dollars (in billions)

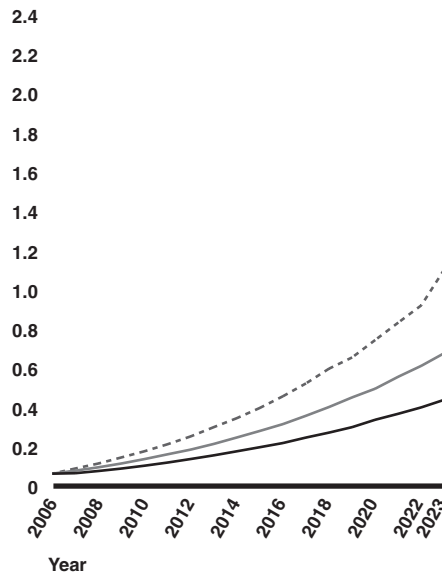


Trust fund balance in 2023

10 th percentile	\$0.439
Median	0.612
90 th percentile	0.862

Moderate strategy

U.S. dollars (in billions)

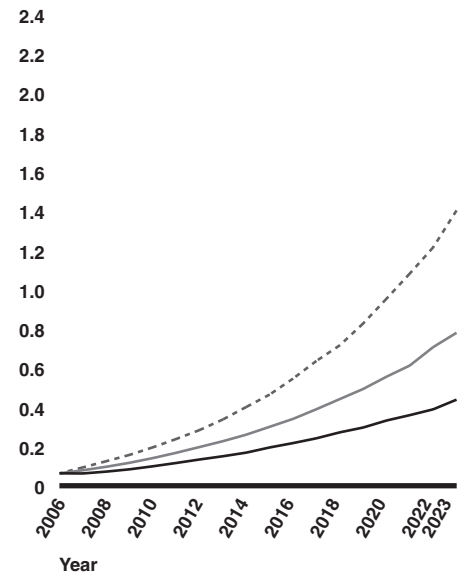


Trust fund balance in 2023

10 th percentile	\$0.439
Median	0.676
90 th percentile	1.103

Aggressive strategy

U.S. dollars (in billions)



Trust fund balance in 2023

10 th percentile	\$0.438
Median	0.778
90 th percentile	1.401

— 10th percentile
 - - - Median
 90th percentile

Source: GAO.

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