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COMPACTS OF FREE ASSOCIATION

Implementation of New Funding and Accountability Requirements Is Well Under Way, but Planning Challenges Remain



G A O

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Highlights of [GAO-05-633](#), a report to congressional requesters

COMPACTS OF FREE ASSOCIATION

Implementation of New Funding and Accountability Requirements Is Well Under Way, but Planning Challenges Remain

Why GAO Did This Study

From 1987 to 2003, the United States provided economic aid to the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) through a Compact of Free Association. A previous GAO report found little accountability for the assistance provided by the U.S. Department of the Interior under this compact. In 2004, amended compacts with the FSM and RMI went into effect and will provide \$3.5 billion in assistance over 20 years, consisting of grants and contributions to trust funds that are to replace the grants after 2023. The amended compacts include funding and accountability requirements that were not present in the original compact. To better understand the status of the compacts' implementation, GAO evaluated actions taken by the U.S., FSM, and RMI governments since fiscal year 2004 to (1) meet funding requirements and plan for the use of this funding, (2) meet accountability requirements, and (3) establish operations to implement the new agreements.

What GAO Recommends

GAO recommends that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs to assess on-site review and, along with officials from the Departments of State and Health and Human Services, work with the FSM and RMI governments to improve oversight and planning.

www.gao.gov/cgi-bin/getrpt?GAO-05-633.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David Gootnick at (202) 512-4128, gootnickd@gao.gov.

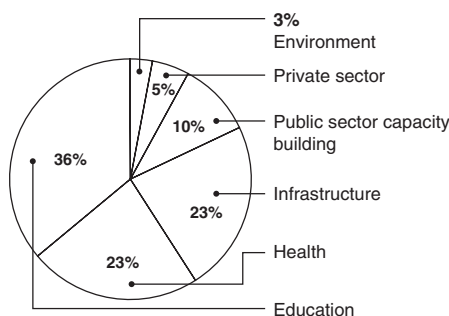
What GAO Found

In fiscal years 2004 and 2005, the U.S. government signed grant agreements with the FSM and the RMI focused on six sectors, such as health and education, as provided for in the amended compacts. Authorized grant amounts for each year were about \$76 million for the FSM and about \$35 million for the RMI (see figure below for fiscal year 2005 grant allocations). Required trust funds were also established. Strategic planning issues impacting the long-term, effective use of funds have not been addressed. The allocations of the grants to the sectors have not been linked to the countries' development goals; the FSM and RMI have not planned for annual required decreases in grant funding; and trust funds have not been invested to maximize interest earnings (though efforts are currently under way to resolve this final issue).

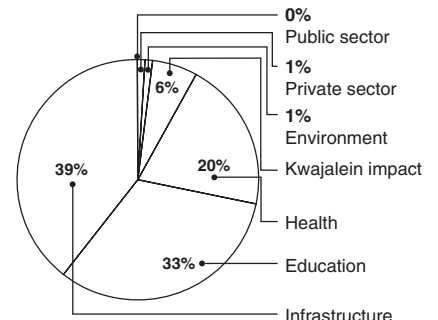
The U.S., FSM, and RMI governments have taken actions to meet compact accountability requirements. For example, the FSM and the RMI have provided financial and performance reports, and the U.S. government has withheld funding to ensure compliance with grant requirements. However, a few important accountability requirements have not been met. For instance, the FSM's development plan has not been approved by the U.S. government, and it is unclear whether the U.S. government has assessed the RMI's planning documents. Finally, the FSM has not completed single audits for fiscal years 2003 or 2004, and none of the three governments has submitted its required annual compact spending and development report for fiscal year 2004.

The Department of the Interior took a significant step in October 2003 to facilitate implementation and oversight of the amended compacts by opening a new office in Honolulu, Hawaii. However, Interior has not determined how much oversight of compact activities in the FSM and the RMI is necessary, though the current level of on-site review is viewed as insufficient. The FSM and RMI governments have each taken actions to establish centralized compact management offices; the RMI government is progressing more rapidly in these efforts than the FSM government.

FSM Sector Grant Allocation of \$76 Million



RMI Sector Grant Allocation of \$34.9 Million



Source: FSM and RMI fiscal year 2005 sector grant agreements and discussions with an OIA official.

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Abbreviations

CNMI	Commonwealth of the Northern Mariana Islands
FPA	Fiscal Procedures Agreement
FSM	Federated States of Micronesia
HHS	Department of Health and Human Services
JEMCO	Joint Economic Management Committee (FSM)
JEMFAC	Joint Economic Management and Financial Accountability Committee (RMI)
KADA	Kwajalein Atoll Development Authority
MTBIF	Medium-Term Budget and Investment Framework (RMI)
OIA	Office of Insular Affairs
RMI	Republic of the Marshall Islands
SEG	Supplemental education grant

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United States Government Accountability Office
Washington, D.C. 20548

July 11, 2005

The Honorable Pete V. Domenici
Chairman
The Honorable Jeff Bingaman
Ranking Minority Member
Committee on Energy and Natural Resources
United States Senate

The Honorable Richard W. Pombo
Chairman
The Honorable Nick J. Rahall, II
Ranking Minority Member
Committee on Resources
House of Representatives

Since fiscal year 1987, the United States has provided economic assistance to the Pacific island nations of the Federated States of Micronesia (FSM)¹ and the Republic of the Marshall Islands (RMI) through a Compact of Free Association. In 2000, we reviewed the accountability over, and impact of, this compact funding and determined that the U.S., FSM, and RMI governments had all provided limited accountability over spending and that U.S. assistance had resulted in little impact on economic development in both countries.² Funding under the original compact expired at the end of fiscal year 2003. The U.S. government negotiated new compact provisions with the FSM and the RMI that established continued U.S. economic assistance from fiscal year 2004 through fiscal year 2023, with the U.S. Department of the Interior's Office of Insular Affairs (OIA) responsible for providing U.S. assistance and monitoring expenditures. The "amended" compacts with the RMI and the FSM, which will provide an estimated \$3.5 billion in U.S. assistance over 20 years, went into effect on May 1, 2004, and June 25, 2004, respectively.³

¹The FSM is comprised of the four states of Chuuk, Kosrae, Pohnpei, and Yap.

²See 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).

³Whereas the original compact (approved in U.S. Public Law 99-239, Jan. 14, 1986) was one agreement between the U.S., FSM, and RMI governments, the amended compacts (approved in U.S. Public Law 108-188, Dec. 17, 2003) are separate agreements between the United States and each of the two countries.

The amended compacts are substantially different from the original compact in that they contain several new funding and accountability provisions. The amended compacts establish annual funding levels (\$92.7 million for the FSM and \$57.7 million for the RMI in fiscal year 2004) that are divided primarily between direct grant assistance, which is targeted to specific areas, with priority in the health and education sectors, and contributions to trust funds.⁴ U.S. grant funding will decrease annually, with the amount of the decrement added to U.S. trust fund contributions; earnings from the trust funds are intended to replace grant assistance when the latter expires in 2023. In addition, numerous accountability requirements have been added to the amended compacts, including requirements for quarterly financial and performance reports and strengthened bilateral interaction.

To obtain insights regarding initial efforts to implement the amended compacts, we evaluated actions taken by the U.S., FSM, and RMI governments since fiscal year 2004 to (1) meet compact funding requirements and plan for the use of this funding, (2) meet compact accountability requirements, and (3) establish operations to facilitate compliance with funding and accountability requirements.

We reviewed the amended compacts as well as the subsidiary fiscal procedures agreements and trust fund agreements. We further reviewed grant agreements as well as budgets, financial data, and performance reports submitted by the FSM and RMI governments to the U.S. government. We also examined briefing documents created by the U.S. government in preparation for annual meetings with the two countries. We assessed the minutes summarizing the discussion and decisions from these meetings. We held extensive interviews with officials from OIA and the U.S. Department of State. In addition, we traveled to the FSM (Pohnpei and Chuuk) and the RMI (Majuro and Ebeye). We had detailed discussions with FSM and RMI officials from finance, budget, health, education, public works, and audit agencies, and we also obtained the views of U.S. government officials working in each country. (See app. I for more detailed information on our scope and methodology.)⁵

⁴The total amount of funding for grants and trust fund contributions is fixed for the 20-year period and is provided through a permanent congressional appropriation.

⁵Per the compacts' enabling legislation, we will conduct an extensive review of implementation, oversight, and impact of the amended compacts by December 2006.

Results in Brief

The U.S. government has signed sector grant agreements with the FSM and RMI as provided for in the amended compacts, and trust funds have been established for both countries; however, certain issues call into question the three governments' planning for the long-term use of funds. For fiscal years 2004 and 2005, the U.S. government signed sector grant agreements with the countries in areas such as health and education. FSM grants totaled about \$76 million annually, with the largest grants for health and education, while RMI grants totaled \$35 million annually, with the largest grants for infrastructure and education.⁶ In addition, trust funds have been established for each country to replace grant assistance after 2023. The FSM and the RMI each did not spend about one-third of their available compact funds for fiscal year 2004. The FSM did not complete sufficient planning required to obtain infrastructure grant funds, while the RMI did not complete plans and certain reforms necessary for the use of some funding targeted for Kwajalein Atoll. In addition, both countries did not spend portions of other sector grants.⁷ Strategic planning issues that impact the long-term, effective use of funds have not been addressed by the three governments: (1) the allocations of sector grants are not linked to amended compact development goals such as the promotion of economic advancement and budgetary self-reliance, (2) the FSM and RMI have not developed strategic plans to manage required annual grant funding decreases, and (3) the trust funds have not been placed with investors that can maximize trust fund earnings (although efforts are currently under way to resolve this issue).

The three governments have taken a number of actions to fulfill key compact accountability requirements, but a few important requirements have not been met. The U.S. government held bilateral meetings with both countries for the past 2 fiscal years to approve grant agreements and held an additional meeting with the FSM in 2005 to discuss, among other issues, the FSM's plan for use of infrastructure funding. In addition, the grants contained numerous special terms and conditions, such as requiring the FSM and the RMI to collect sector data and establish a framework for

⁶Although the amended compacts did formally not go into effect until May and June of 2004, OIA's Compact Coordinator reported that all three countries agreed to proceed according to compact terms at the beginning of fiscal year 2004. Fiscal year 2004 signed grant agreements commit the FSM and the RMI to abide by the terms of the amended compacts and their related agreements. The FSM and RMI governments use the same fiscal year as the U.S. government (October through September).

⁷This funding will remain available for use in future years.

performance measurement. According to OIA officials, the RMI has met most of the terms and conditions attached to its grants, but the FSM has met only some of the terms and conditions for its grants. Both the FSM and the RMI have provided the U.S. government with all required quarterly performance and financial reports for fiscal years 2004 and 2005. However, OIA officials viewed the FSM's early performance reports as inadequate, and FSM and RMI officials reported that they are still learning how to prepare such reports. Further, the U.S. government has made use of a key accountability option that allows for the withholding or suspension of funds; for example, certain compact education funding for the FSM state of Chuuk has been suspended due to possible misuse. A few important actions required under the amended compacts have not yet been completed. For example, the FSM has not completed required audits for fiscal year 2003 and 2004, and none of the three governments has submitted the required annual compact spending and development report for fiscal year 2004.

The U.S. government has made significant progress in establishing operations to facilitate the amended compacts' implementation and oversight, and the FSM and the RMI governments have taken initial steps. In October 2003, OIA opened an office in Honolulu, Hawaii, to facilitate implementation and provide oversight of the various compact sector grants. However, OIA has not determined the extent of on-site review in the FSM and the RMI that is necessary to adequately promote compliance with compact and grant requirements. Officials from all three countries told us that while they view the creation of OIA's Honolulu office as a positive development, they believe that the Honolulu staff should spend more time in the FSM and the RMI than they currently do, to provide additional guidance on meeting compact requirements and conduct site visits. During fiscal year 2004 through mid-April 2005, Honolulu staff spent about 15 percent of their time in the FSM and the RMI. In early 2005, the RMI government determined that its Office of the Chief Secretary will serve as the central office responsible for compact issues, overseeing and coordinating the grants' implementation. The FSM government recently passed legislation to create a central compact management office to oversee compact matters and communicate with the U.S. government, although this office is not yet operating. Further, the RMI has created a unit that is currently managing infrastructure projects, while the FSM just created such a unit in June 2005.

In this report, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs to review the extent of OIA

oversight in the FSM and the RMI that is necessary to promote compact compliance and, along with officials from the Departments of State and Health and Human Services (HHS), work with the FSM and RMI governments to improve oversight and planning.

We provided a draft of this report to the Departments of the Interior, State, and HHS. We also provided a draft to the FSM and RMI governments. We received technical comments from the three U.S. agencies and the two Micronesian governments, which we have incorporated into this report, as appropriate. We also received formal letters from all parties. Reproductions of these letters, as well as our responses to the letters, can be found in appendixes IV through VIII. All letters found our work to be useful. The Department of the Interior concurred with our recommendations and expressed its intention to implement them. State, HHS, and the FSM government did not comment on our recommendations to Interior. The RMI government stated that some of the recommendations did not reflect the purpose or intent of the amended compact.

Background

Since the FSM and the RMI became sovereign nations, the U.S. relationship with the two countries has been defined by the original Compact of Free Association and the subsequent amended Compacts of Free Association.

Compact of Free Association, 1986 through 2003

In 1986, the United States, the FSM and the RMI entered into the Compact of Free Association. This compact represented a new phase of the unique and special relationship that has existed between the United States and these island areas since World War II. 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. The first goal was met; the FSM and the RMI are independent nations and are members of international organizations such as the United Nations. The second goal was also achieved. At the time that the compact was negotiated, the United States was concerned about the use of the islands of the FSM and the RMI as “springboards for aggression” against the United States, as they had been used in World War II, and the Cold War incarnation of this threat—the Soviet Union. The compact and its related agreements established several key defense rights for all three countries. For example, the compact obligates the United States to defend the FSM

and the RMI against an attack, or the threat of attack, in the same way it would defend its own citizens. Further, through a compact-related agreement, the United States secured access to military facilities on Kwajalein Atoll in the RMI through 2016.⁸

The third goal of the compact—advancing economic development and self-sufficiency for both countries—was to be accomplished primarily through U.S. direct financial payments to the FSM and the RMI. For 1987 through 2003, U.S. assistance to the FSM and the RMI to support economic development was estimated, on the basis of Interior data, to be about \$2.1 billion. We found previously that many compact-funded projects in the FSM and the RMI experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds. Economic self-sufficiency had advanced but had not been achieved; although total U.S. assistance as a percentage of total government revenue fell in both countries, the two nations remained dependent on U.S. funds. U.S. direct assistance maintained standards of living that were higher than could be achieved in the absence of U.S. support.

Another aspect of the special relationship between the FSM and the RMI and the United States involves the unique immigration rights that the compact grants. Under the original compact, citizens of both nations were allowed to live and work in the United States as “nonimmigrants” and could stay for long periods of time, with few restrictions. Further, the compact exempted FSM and RMI citizens from meeting U.S. passport, visa, and labor certification requirements when entering the United States. In recognition of the potential adverse impacts that Hawaii and nearby U.S. commonwealths and territories could face as a result of an influx of FSM and RMI citizens, the Congress authorized compact impact payments to address the financial impact of these nonimmigrants on Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands (CNMI).⁹

⁸In a previous report, we discussed the importance of Kwajalein Atoll to U.S. defense interests in the region. See GAO, *Foreign Relations: Kwajalein Atoll Is the Key U.S. Defense Interest in Two Micronesian Nations*, [GAO-02-119](#) (Washington, D.C.: Jan. 22, 2002).

⁹In 2001 we reported on the impact of nonimmigrants in Guam, Hawaii, and the CNMI and the amount of impact funding that has been provided to the locations. See GAO, *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).

Amended Compacts of Free Association

In the fall of 1999, the United States, represented by the Department of State, and the two Pacific island nations began negotiating economic assistance and defense provisions of the compact that were due to expire in 2003. The negotiations also addressed immigration issues. Separate compacts were completed for the RMI and the FSM and went into effect on May 1, 2004, and June 25, 2004, respectively. Prior to formal implementation of the amended compacts, the United States provided funding via a continuing resolution and the Department of the Interior's fiscal year 2004 appropriation legislation. According to the Department of State, the aims of the amended compacts are to (1) continue economic assistance to advance self-reliance, while improving accountability and effectiveness; (2) continue the defense relationship, including a 50-year lease extension (beyond 2016) of U.S. military access to Kwajalein Atoll in the RMI; (3) strengthen immigration provisions; and (4) provide assistance to lessen the impact of Micronesian migration on Guam, Hawaii, and the CNMI.

The amended compacts' second objective, continuing the U.S.-RMI defense relationship, has been addressed, as expiring defense provisions of the compact have been renewed and U.S. access to Kwajalein Atoll has been extended. However, one notable difficulty remains regarding this objective; although the U.S. government negotiated an agreement with the RMI government that allows for U.S. access to Kwajalein Atoll until 2086, 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. The U.S. government is not involved in efforts to negotiate such an agreement, and neither the RMI government nor the Kwajalein Atoll landowners are actively pursuing resolution of this issue. The third and fourth objectives have also been addressed. Compact immigration provisions have been strengthened by, for example, requiring passports from FSM and RMI citizens entering the United States and clarifying requirements for bringing FSM and RMI children into the United States for adoption. Further, the amended compacts' enabling legislation appropriates specific annual nonimmigrant impact compensation of \$30 million for Guam, Hawaii, and the CNMI for fiscal years 2004 through 2023, with the distribution of funding between the locations based on periodic

surveys identifying the number of FSM and RMI nonimmigrants in each location.¹⁰

Continuing Economic Assistance under Amended Compacts

The U.S. government intends to achieve its first objective—continuing economic assistance to advance self-reliance, while improving accountability and effectiveness under the amended compacts—by annually providing direct financial assistance, in the form of grant agreements, to the FSM and the RMI, for 20 years (fiscal years 2004 through 2023) (see tables 1 and 2). Grant assistance to the FSM and RMI is targeted to six specific sectors—education, health, public infrastructure, the environment, public sector capacity building, and private sector development—although the priority sectors are education and health. RMI grants must also target some funding to Ebeye and other Marshallese communities within Kwajalein Atoll. The U.S. Congress, in approving the amended compacts, also authorized a supplemental education grant for each country. The Congress determined that rather than remaining eligible for appropriations under certain education and labor program assistance, such as Head Start and Job Corps, the FSM and the RMI would instead receive supplemental direct grant assistance.¹¹

In addition to providing sector grant funds, the amended compacts provide for the establishment of trust funds for both countries. While providing the direct grant assistance, the U.S. government will also contribute to the trust funds for both countries, and the FSM and the RMI will replace the grant assistance with trust fund earnings beginning in 2024. In addition, the FSM and the RMI must each make one-time contributions to its trust fund of \$30 million, and other donors can contribute to the funds as well. Except for the fixed amounts set aside as audit grants, the amounts listed in tables 1 and 2 will be partially adjusted for inflation, with fiscal year 2004 as the base year. Grant funding can be fully adjusted for inflation after fiscal year 2014 under certain economic conditions. Including estimated inflation adjustments, total U.S. assistance to both countries combined is projected at more than \$3.5 billion over the 20-year assistance period.

¹⁰American Samoa is also eligible for compact impact funding, and nonimmigrants from the Republic of Palau are included in the periodic surveys.

¹¹The amended compacts also authorize an additional \$300,000, partially adjusted for inflation, for fiscal years 2004 through 2023 for the training of judges and officials of the judiciary in the FSM and the RMI.

Table 1: U.S. Assistance to Be Provided to the Federated States of Micronesia under the Terms of the Amended Compact, Fiscal Years 2004-2023

Budget authority in millions of dollars

Fiscal year	Annual grants Section 211	Audit grant Section 212(b) (amount up to)	Trust fund Section 215	Total
2004	\$76.2	\$.5	\$16.0	\$92.7
2005	76.2	.5	16.0	92.7
2006	76.2	.5	16.0	92.7
2007	75.4	.5	16.8	92.7
2008	74.6	.5	17.6	92.7
2009	73.8	.5	18.4	92.7
2010	73.0	.5	19.2	92.7
2011	72.2	.5	20.0	92.7
2012	71.4	.5	20.8	92.7
2013	70.6	.5	21.6	92.7
2014	69.8	.5	22.4	92.7
2015	69.0	.5	23.2	92.7
2016	68.2	.5	24.0	92.7
2017	67.4	.5	24.8	92.7
2018	66.6	.5	25.6	92.7
2019	65.8	.5	26.4	92.7
2020	65.0	.5	27.2	92.7
2021	64.2	.5	28.0	92.7
2022	63.4	.5	28.8	92.7
2023	62.6	.5	29.6	92.7

Source: Compact of Free Association, as Amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia, U.S. Public Law 108-188.

Note: Within the annual grant amounts, \$200,000 will be provided directly by the Secretary of the Interior to the U.S. Department of Homeland Security, Federal Emergency Management Agency for disaster and emergency assistance purposes.

Table 2: U.S. Assistance to Be Provided to the Republic of the Marshall Islands under the Terms of the Amended Compact, Fiscal Years 2004-2023

Budget authority in millions of dollars

Fiscal year	Annual grants Section 211	Audit grant Section 213(b) (amount up to)	Trust fund Section 216	Kwajalein impact Section 212	Total
2004	\$35.2	\$.5	\$7.0	\$15.0	\$57.7
2005	34.7	.5	7.5	15.0	57.7
2006	34.2	.5	8.0	15.0	57.7
2007	33.7	.5	8.5	15.0	57.7
2008	33.2	.5	9.0	15.0	57.7
2009	32.7	.5	9.5	15.0	57.7
2010	32.2	.5	10.0	15.0	57.7
2011	31.7	.5	10.5	15.0	57.7
2012	31.2	.5	11.0	15.0	57.7
2013	30.7	.5	11.5	15.0	57.7
2014	32.2	.5	12.0	18.0	62.7
2015	31.7	.5	12.5	18.0	62.7
2016	31.2	.5	13.0	18.0	62.7
2017	30.7	.5	13.5	18.0	62.7
2018	30.2	.5	14.0	18.0	62.7
2019	29.7	.5	14.5	18.0	62.7
2020	29.2	.5	15.0	18.0	62.7
2021	28.7	.5	15.5	18.0	62.7
2022	28.2	.5	16.0	18.0	62.7
2023	27.7	.5	16.5	18.0	62.7

Source: Compact of Free Association, as Amended, Between the Government of the United States of America and the Government of the Republic of the Marshall Islands, U.S. Public Law 108-188.

Notes:

“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.

Beginning in 2014, the total amount of funding provided to the RMI will increase by \$5 million. Of this amount, \$3 million is allocated to “Kwajalein Impact,” while an additional \$2 million is added to annual grants to address the special needs of Kwajalein Atoll.

Within the annual grant amounts, \$200,000 will be provided directly by the Secretary of the Interior to the U.S. Department of Homeland Security, Federal Emergency Management Agency for disaster and emergency assistance purposes.

Accountability Requirements under Amended Compacts

The amended compacts and their subsidiary fiscal procedures agreements (FPA) also establish numerous new accountability requirements.¹² For example, under the amended compacts, the United States established a Joint Economic Management Committee (JEMCO) with the FSM and a Joint Economic Management and Financial Accountability Committee (JEMFAC) with the RMI to strengthen management and accountability and to promote the effective use of the compact funding. Each committee comprises five members, three from the United States and the other two from the FSM for the JEMCO and from the RMI for the JEMFAC. The Departments of the Interior, State, and HHS supply the three U.S. representatives, with the Department of the Interior representative serving as Chairman.¹³ The FSM and RMI governments select their respective representatives. The amended compacts require the committees to meet at least once annually, no later than 30 days before the beginning of the fiscal year, to review the budgeting and development plans of each of the governments, approve grant allocations and performance objectives, attach special conditions to any or all annual grant awards to improve program performance and fiscal accountability, and evaluate progress made under the amended compacts. JEMCO and JEMFAC render decisions by majority vote, except decisions regarding the division of RMI grants, which are made by consensus. Budget consultations with each country are also required prior to JEMCO and JEMFAC meetings to ensure that proposed compact budgets estimate sector grant requirements for the upcoming fiscal year. In addition, trust fund committees are required to address issues associated with the operations and investments of the FSM and RMI trust funds. The trust fund committee for each country is comprised of

¹²There is a so-called “fiscal procedures agreement” with the FSM as well as the RMI. These agreements are formally known as the “Agreement Concerning Procedures for the Implementation of United States Economic Assistance Provided in the Compact of Free Association, as amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia” and the “Agreement Concerning Procedures for the Implementation of United States Economic Assistance Provided in the Compact, as amended, of Free Association Between the Government of the United States of America and the Government of the Republic of the Marshall Islands.” These two agreements contain detailed requirements concerning implementation of the amended Compacts’ funding and accountability provisions.

¹³While the Departments of the Interior and State have an extensive history of involvement with compact issues, HHS was interested in direct involvement with the amended compacts due to the department’s long history of providing assistance to the FSM and the RMI (via programs such as Head Start, which is now being phased out of both countries) and its desire to continue its commitment to the islands. The islands remain eligible for a number of HHS categorical and competitive grant programs for which the department has an obligation to maintain oversight and accountability.

representatives from the United States and the FSM or the RMI, and other contributors may also join the committees. Language contained in the amended compacts' enabling legislation states that it is the sense of the U.S. Congress that U.S. appointees to the trust fund committees "should be designated from the Department of State, the Department of the Interior, and the Department of the Treasury."

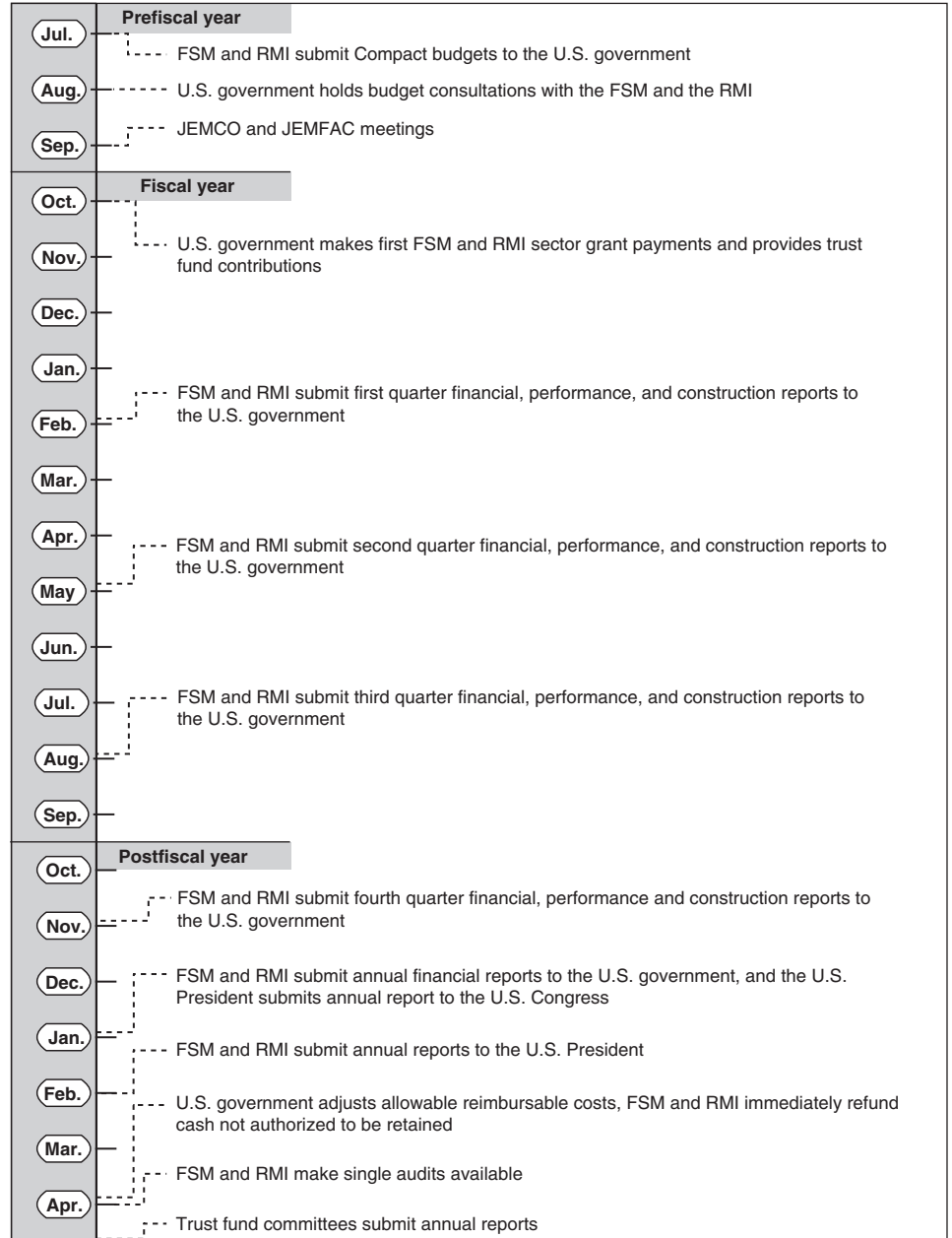
The FSM and RMI must also adhere to specific financial and performance reporting requirements as part of the amended compacts and the FPAs. The FPAs state that financial management systems must meet several standards addressing financial reporting, accounting records, internal and budget controls, cash management, and source documentation, and also specify applicable procedures regarding real property, equipment, and procurement where compact funds are involved. As part of their budgeting process, both countries must submit plans for the division of annual economic assistance among sectors. Additionally, per the terms of the FPAs, the FSM and RMI must submit quarterly financial status and cash transaction reports, and final annual financial reports and single audits¹⁴ must be completed following the end of each fiscal year.¹⁵ Further, for each sector grant, the FSM and RMI must submit quarterly performance reports comparing actual accomplishments with program objectives and identifying any problems or issues encountered during the reporting period. The FSM and RMI are responsible for the management and monitoring of the day-to-day operations of all sector grants and their activities to ensure compliance with all grant terms and conditions. In addition, the FSM and RMI must prepare and submit an annual report to the President of the United States on the use of grant assistance and describe progress toward mutually agreed-upon program and economic goals. Similarly, the President of the United States must submit an annual report to the Congress regarding several issues such as general social, political, and economic conditions in each country; the use and effectiveness of financial assistance; status of efforts to increase investments; and recommendations on ways to increase the effectiveness of assistance and to meet overall economic performance objectives. (See

¹⁴A "single audit" is a financial and compliance audit, within the meaning of the Single Audit Act, as amended. See 31 U.S.C. § 7501 et seq. The Single Audit Act is intended to, among other things, promote sound financial management, including effective internal controls, with respect to the use of federal awards.

¹⁵Annual financial reports and single audits are due December 31 and April 1, respectively, following the end of the fiscal year.

fig. 1 for a time line of key funding and accountability events that are required for each fiscal year.)

Figure 1: Time Line of Key Compact Funding and Accountability Event Deadlines Associated with One Fiscal Year



Sources: U.S. Public Law 108-188, FSM and RMI Fiscal Procedures Agreements.

Note: Grant funding is provided to each country on a monthly basis, except for the first month of the fiscal year when funding is provided to cover the first 2 months of the year. However, infrastructure

projects and projects that are not funded by other grants are paid on the basis of accrued expenditures.

OIA staff work closely with Department of State staff in Washington, D.C. and the U.S. embassies in the FSM and the RMI regarding compact matters. Department of State officials emphasized to us that they are primarily responsible for conducting foreign relations with the two countries and safeguarding U.S. strategic interests in the region, and these objectives necessarily include involvement in compact issues. An executive order is currently under preparation that identifies the specific responsibilities of U.S. agencies regarding compact matters. Further, OIA coordinates with HHS, a U.S. JEMCO and JEMFAC member, and in February 2005 a senior official from HHS began work in OIA's Honolulu field office (which opened in 2003) and told us that he provides support to the OIA health sector efforts under the amended compacts, provides technical assistance for an array of U.S. federal health grants in the Pacific, and works to improve coordination with other public health entities in the region, such as the World Health Organization.

Key Differences between Original Compact and Amended Compacts

The amended compacts differ from the original compact chiefly in that they provide for direct assistance through sector grant agreements, establish trust funds, and strengthened accountability and reporting provisions (all discussed earlier). In addition, unlike the original compact, the amended compacts do not include a "full faith and credit" guarantee, which had made it impracticable for the U.S. government to withhold compact funds. Instead, the FPAs contain provisions that explicitly allow for the withholding of funds if compact, FPA, or grant requirements are not met. Further, the FPAs allow for the suspension of funds if the FSM or RMI engage in gross negligence, willful misconduct, or material breach of terms and conditions with respect to the use of financial assistance provided under the amended compacts. In addition, funds can be withheld if the FSM and RMI do not cooperate in investigations regarding whether funds are being used for purposes outside what is authorized in the compact.

Finally, the FPAs prohibit the FSM and RMI from issuing negotiable or transferable obligations evidencing indebtedness or encumbrance of compact economic assistance funds. In 2000, we found that under the original compact, the FSM and the RMI issued compact revenue-backed bonds in order to obtain greater funding in the earlier years of the compact. The funding was used to retire existing debt, pay for capital projects, and make financial investments. In later compact years, FSM and RMI bond

debt payments (especially for the RMI) limited the availability of compact funds for other uses.

United States Is Providing Compact Funding to the FSM and the RMI, but Strategic Issues Impacting Long-Term Use of Funds Have Not Been Addressed

The U.S. government has signed sector grant agreements with the FSM and RMI as provided for in the amended compacts, and trust funds for both countries have been established. The two countries did not spend about one-third of available funding in fiscal year 2004. Some of this unspent funding resulted from a lack of planning required to obtain access to certain grants—the FSM did not complete plans to obtain infrastructure grant funding and for the RMI did not complete plans and reforms for the use of funds targeted to address the special needs of Kwajalein Atoll. The U.S. government has not provided either country with a supplemental education grant established in the amended compact's enabling legislation. Strategic planning issues that impact the long-term, effective use of funds have not been addressed by the three governments: (1) the allocations of sector grants are not linked to amended compact development goals such as the promotion of economic advancement and budgetary self-reliance, (2) the FSM and RMI have not developed strategic plans to manage required annual grant funding decreases, and (3) the trust funds have not been placed with investors that can maximize trust fund earnings (although efforts are under way to resolve this issue).

U.S. Government Signed Grant Agreements with Both Countries, and Trust Funds Have Been Established

The U.S. government signed grant agreements with the FSM and the RMI for fiscal years 2004 and 2005¹⁶ in the compact-designated areas of health, education, infrastructure, environment, private sector, and public sector capacity building (see fig. 2 for FSM and RMI fiscal year 2005 grant allocations). FSM sector grant funding totaled \$76 million annually for both years.¹⁷ The FSM national government, which directly signs grant agreements with the U.S. government and is the “grantee,” provides the

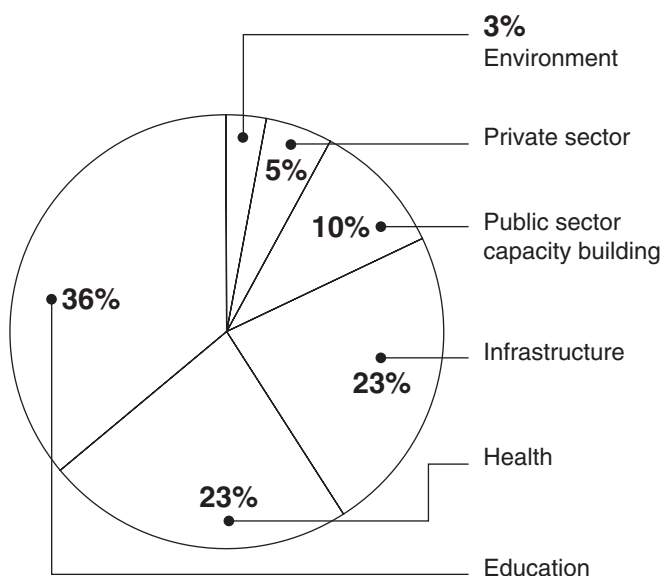
¹⁶The U.S. and FSM governments did not sign an infrastructure grant agreement for fiscal year 2005 until May 2005. Further, the U.S. government has not signed grant agreements for fiscal years 2004 and 2005 to provide \$1.9 million in annual funding to Kwajalein Atoll, nor did the RMI allocate funding for a public sector capacity building grant in fiscal year 2004.

¹⁷According to an Interior official, the FSM government failed to initially adjust fiscal year 2005 sector grants to include an inflation amount of \$1,117,200; this amount will be added to grant amounts for fiscal year 2006.

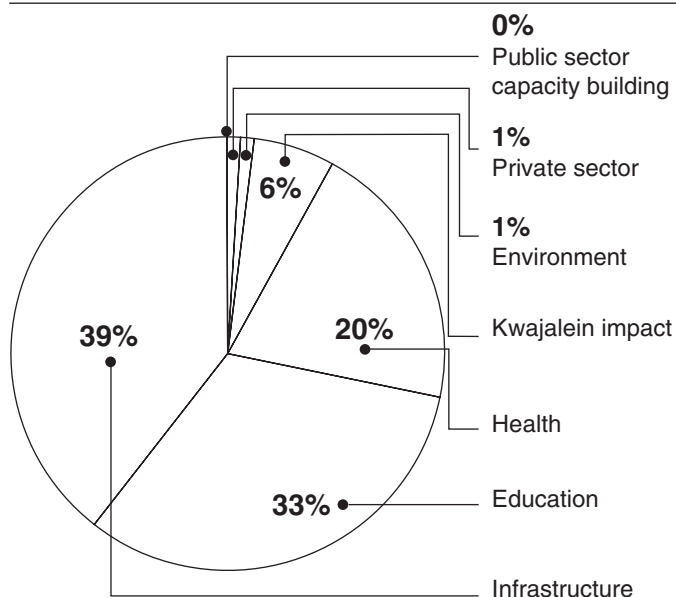
majority of grant funds to the four FSM states, which are “subgrantees.” RMI grant funding totaled about \$35 million annually for the 2 years.¹⁸

Figure 2: FSM and RMI Sector Grant Allocation, Fiscal Year 2005

FSM Sector Grant Allocation of \$76 Million



RMI Sector Grant Allocation of \$34.9 Million



Source: FSM and RMI fiscal year 2005 sector grant agreements and discussions with an OIA official.

Notes:

The RMI's public sector capacity building grant was \$103,514. This amount accounts for under 1 percent of total grant funding.

While section 211(b)(2) of the amended compact with the RMI provides for an annual \$1.9 million (with a partial inflation adjustment) for Kwajalein impact, these funds have not yet been provided pending the completion of a spending plan for these funds.

- The FSM's largest grant for fiscal years 2004 and 2005 is in the area of education. This grant accounted for over a third of total sector grants. The health sector received the second highest grant amount for 2005, at

¹⁸The RMI government has five subgrantees that receive a small amount of compact funding. These subgrantees are the College of the Marshall Islands, the Marshall Islands Visitors Authority, the Scholarship Board, the Land Registration Authority, and the Kwajalein Atoll Joint Utility Resources. These subgrantees received less than 1 percent of compact grant funding in fiscal year 2004.

23 percent of total grant funding. The FSM has not yet met the goals outlined in the amended compacts' enabling legislation, which states that it is the sense of the U.S. Congress that infrastructure improvements and maintenance should account for not less than 30 percent of all sector grant funding each year; the amount of funding intended for infrastructure for 2005 is slightly smaller than the funding for health grants and also accounted for about 23 percent of grant funding in that year (a grant in this area was awarded by Interior on May 13, 2005, and accepted by the FSM national government on May 26, 2005). A resolution adopted by the JEMCO during an August 2004 meeting requires the FSM to move to reach the goal of funding infrastructure at not less than 30 percent of annual compact grant funding by fiscal year 2006. In addition, the United States agreed to an FSM request for fiscal year 2004 to spend about 90 percent of its \$11.6 million public sector capacity building grant to fund basic government operations, rather than to support this sector's principal compact objective of promoting effective, accountable, and transparent government. According to a senior OIA official, the FSM needed to use these grant funds for basic government operations to be able to adequately support the use of other sector grant funds. As a 2004 grant condition, the FSM is required to stop funding basic government operations from Compact grant assistance over a 5-year period. Similarly, in 2004, the FSM also had to commit to shifting basic government operations out of its much smaller private sector development grant—a grant primarily intended to support efforts to attract new foreign investment and increase indigenous business activity.

- The RMI's largest grant for fiscal years 2004 and 2005 is in the area of infrastructure. The RMI has easily met the "sense of the U.S. Congress" language regarding infrastructure for fiscal years 2004 and 2005, with an infrastructure grant of about \$13.5 million accounting for around 39 percent of total sector grant funding in 2005. The next largest grant is in the area of education, which represents more than 30 percent of total grant funding for both years, followed by health grants at 20 percent of the total funding. An additional grant of \$1.9 million authorized in amended compact section 211(b)(2) (representing 6 percent of total grant funds in fiscal year 2005) exists specifically to address needs on

Kwajalein Atoll, although grant documents had not been signed as of mid-May 2005.¹⁹ In contrast to the FSM, the RMI allocated no compact funding to a public sector capacity building grant in fiscal year 2004 and less than 1 percent of compact sector grant funding to such a grant in fiscal year 2005. (For a more detailed description of FSM and RMI sector grant allocations for fiscal years 2004 and 2005, see app. II.)

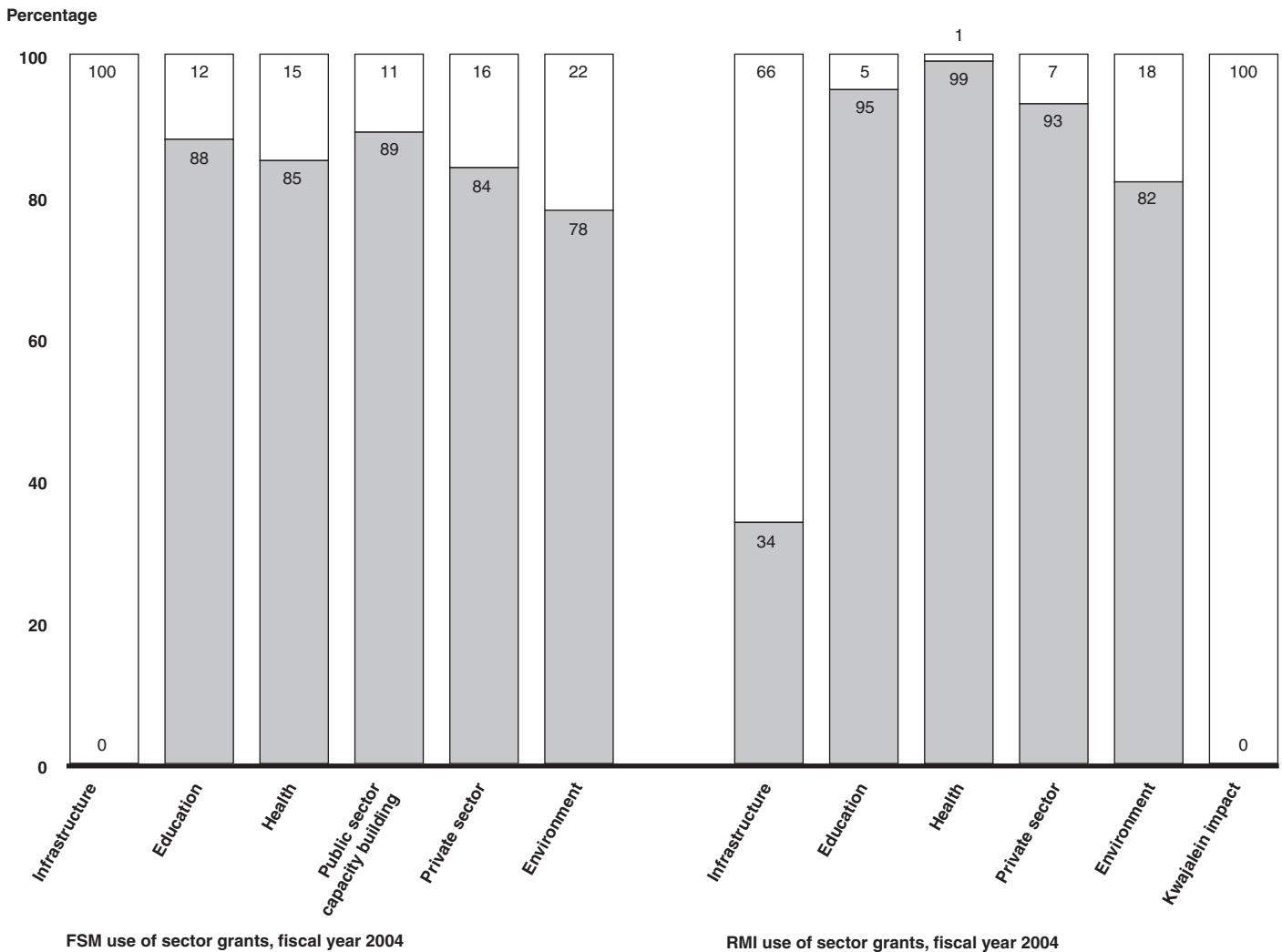
As provided by the amended compacts, trust funds have been established for both countries, the earnings from which are to replace sector grants when grant assistance ends in 2023. According to an OIA official, the RMI trust fund was incorporated in April 2004, and the FSM trust fund was incorporated in August of that year. The FSM government contributed \$30 million to its trust fund in October 2004, while the RMI government, as of March 2005, had contributed \$26.5 million to its trust fund and was \$1 million behind with its scheduled trust fund contributions. As provided in the amended compacts, the U.S. government has provided \$32 million to the FSM trust fund and \$14.5 million to the RMI trust fund for fiscal years 2004 and 2005. In addition, according to a State official, the RMI has signed an agreement that will provide for a \$50 million trust fund contribution from Taiwan (which has also provided economic assistance to the RMI).

FSM and RMI Did Not Spend About One-Third of Authorized Fiscal Year 2004 Funds

The FSM and the RMI each did not spend about one-third of authorized grant funding for fiscal year 2004 (the only completed year under the amended compacts). Some of this unspent funding resulted from a lack of planning required to obtain access to certain grants—the FSM did not complete plans to obtain infrastructure grant funding, and the RMI did not complete plans and reforms for the use of funds targeted to address the special needs of Kwajalein Atoll. Further, both countries did not spend (obligate) some portion of other available sector grants for 2004; the FSM spent a smaller percentage of each of these grants than the RMI (see fig. 3 for FSM and RMI use of sector grants for fiscal year 2004). These funds remain available for use in future years.

¹⁹In addition, a certain portion of the RMI's sector grant funding must be used on Kwajalein Atoll, as provided for in amended compact sections 211(b)(1) and 211(b)(3).

Figure 3: FSM and RMI Use of Authorized Sector Grant Funds, Fiscal Year 2004



Unspent sector grant funds
 Spent sector grant funds

Sources: FSM and RMI fiscal year 2004 sector grant agreements, FSM and RMI fiscal year 2004 financial reports.

Notes:

The RMI allocated no compact funding for a public sector capacity building grant in fiscal year 2004.
 The Kwajalein impact funding (\$1.9 million) is specific to the RMI and is authorized in section 211(b)(2) of that country's amended compact.

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- The FSM did not spend almost \$25 million (33 percent) of its authorized sector grant funding of \$76 million for fiscal year 2004. This amount includes more than \$17 million in infrastructure funding (100 percent of the grant amount) that was not provided to the country because of the time it has taken the FSM to complete a required infrastructure development plan that identified infrastructure projects that adequately integrated state and national priorities.²⁰ Further, the FSM has only recently established a required project management unit to oversee individual infrastructure projects.²¹ Finally, the FSM did not spend more than \$7.7 million in other available sector funds (primarily in health and education); OIA officials have expressed frustration that financial management practices in the FSM allowed over 10 percent of the available compact grant funds to go unused for fiscal year 2004. Of this amount, Yap state had the largest unobligated, or carryover, compact fund balance, at more than \$4 million.²²
 - The RMI did not spend about \$12 million (35 percent) of its total authorized grant funds of \$35 million. The RMI, which met compact requirements related to infrastructure spending, did not spend \$9.6 million (66 percent) of its infrastructure grant, owing to the time involved in bidding and initiating infrastructure projects.²³ According to an OIA official, infrastructure activity is now well under way in the RMI. Further, the RMI government did not spend \$1.9 million targeted for special needs on Kwajalein Atoll. These funds remain with OIA until the RMI government submits a plan regarding how the funds will be spent. The funds will be used by a local government agency, the Kwajalein

²⁰At a special JEMCO meeting in March 2005, JEMCO approved portions of the FSM's infrastructure development plan that contemplate use of compact infrastructure sector funds for projects within the priorities established in the FPA.

²¹The FSM national government executed a contract with a firm on May 19, 2005, to undertake project engineering, management, and administration of a project management unit. The consultant team established a physical presence in Pohnpei and became "operational" on June 20, 2005.

²²According to an OIA official, Yap officials report that the state held spending at fiscal year 2003 levels because fiscal year 2004 funds were not provided by the FSM national government until December. Per a 2004 JEMCO resolution, all FSM health and education carry-over funds, amounting to approximately \$5.3 million, will be spent on health and education infrastructure projects.

²³In addition, rather than receiving funding up-front, infrastructure projects are reimbursed on an accrued expenditure basis.

Atoll Development Authority (KADA), which has experienced problems in effectively and efficiently using funds in the past. As of early 2005, legislation had been passed that contains plans for KADA's restructuring, but the agency was not operating. Finally, the RMI had a carry-over balance of about \$750,000 from other available fiscal year 2004 sector grants, chiefly in the education sector (5 percent of funding under this grant, the RMI's second largest for 2004, was unspent for the year).

In addition, the U.S. government has not provided one grant established in the amended compacts' enabling legislation. Neither the FSM nor the RMI has received a supplemental education grant (SEG) that is to begin in fiscal year 2005. The Departments of the Interior, Education, Labor, and Health and Human Services are still finalizing an interagency agreement to determine how funds authorized under the amended compacts' enabling legislation for this grant will be transferred from other agencies to Interior. The annual SEG amount—\$12.23 million for the FSM and \$6.1 million for the RMI—is substantial, compared with the funding amounts provided for other compact sector grants.²⁴

Strategic Issues Impacting Long-Term Use of Funds Have Not Been Addressed

The U.S., FSM, and RMI governments have not addressed several strategic issues that impact the long-term, effective use of funds.

Grant Allocations Not Tied to Broader Goals

Fiscal year 2004 and 2005 allocation of compact sector grant allocations were not clearly tied to broad development goals, and therefore the extent to which existing grants contribute to the FSM's and the RMI's long-term development is unclear. The JEMCO and JEMFAC reviews of sector grant allocations for fiscal years 2004 and 2005 did not include discussions of FSM and RMI plans to establish goals regarding the amended compacts' primary objectives of economic advancement and budgetary self-reliance, and how grant allocations in each sector will help to achieve these larger goals. FSM and RMI plans that could assist in this effort are incomplete. The required development plan for the FSM and the medium-term budget and investment framework (MTBIF) for the RMI are to be strategic in nature and identify how the countries will use compact funds to promote

²⁴The SEG for both countries will be partially adjusted for inflation and is subject to annual appropriations by the U.S. Congress.

broad compact development goals such as economic advancement and budgetary self-reliance.²⁵ However, JEMCO has not considered the FSM development plan. Further, U.S. officials are unclear as to whether JEMFAC has approved RMI's framework plans for the use of grant funds and have acknowledged that this issue needs attention. U.S. government officials have noted that the issue of linking the use of grant funds to the achievement of long-term development goals has not been addressed to this point.

Further, while the amended compact states that grant funding is provided to assist the economic advancement of the people of the FSM, the FSM's process for internally distributing sector grant funding does not address national sector priorities or consider sector disparities between the FSM states. Compact funds are allocated among the five FSM governments—the FSM national government and the four state governments—primarily according to a formula used under the original compact.²⁶ In addition to providing funds to the four states, the formula established funding to the FSM national government, which resulted in a funding allocation percentage for Chuuk and Pohnpei states that is notably lower than their percentage of the FSM's population. An FSM law enacted in January 2005 establishes a very similar distribution among the five governments.²⁷

Although the U.S. government has signed grant agreements for fiscal years 2004 and 2005 that provide for the distribution of funds to the five governments according to this formula, U.S. government officials have stated that this formula may not result in grant allocations that reflect

²⁵While the amended compact with the FSM calls for a development plan, the RMI's amended compact states that the RMI is required to provide the U.S. government with a "medium-term budget and investment framework."

²⁶Once an overall amount of grant funds is allocated to each government according to the formula, the five governments then independently determine how the funds will be allocated across sectors.

²⁷Per the terms of FSM Public Law 13-72, for fiscal years 2005 and 2006, the distribution of Compact sector grants will be as follows: FSM national government – 8.65 percent, Chuuk state – 38.57 percent, Pohnpei state – 25.69 percent, Yap state – 16.03 percent, and Kosrae state – 11.06 percent. By comparison, according to the FSM 2000 Population and Housing Census Report, the population of Chuuk in that year accounted for 50 percent of the FSM population, while Pohnpei accounted for 32 percent, Yap accounted for 11 percent, and Kosrae accounted for 7 percent. Beginning in fiscal year 2007 and beyond, a different distribution formula that provides over 13 percent of total grant funding to the FSM national government will go into effect, absent an alternative arrangement reached between the five governments.

national needs. For example, there are currently substantial differences in sector per capita funding in the FSM states. We calculated that the Yap state compact education grant provides at least twice as much funding per student as the Chuuk state education grant, and almost three times as much funding per person regarding health grants. The extent to which such variances between states benefit the nation or reflect differences in state needs is not clear.

FSM and RMI Have Not Planned for Future Funding Decreases

Lack of strategic planning in both countries to address necessary grant decreases could result in funding allocations that do not facilitate the most critical and effective use of remaining compact resources. For example, the FSM and the RMI have not developed a strategy to manage the annual sector grant decreases—for the FSM, \$800,000 starting in fiscal year 2007 and for the RMI, \$500,000 since fiscal year 2005—mandated in the amended compacts. A senior RMI official told us that although the government recognizes that the decrements should be of major concern, government officials are not addressing the problem. Likewise, a senior FSM official reported that although the government has created a task force to examine ways to increase tax revenues to, among other things, compensate for lost compact grant funding, no plan is currently being devised to determine how to respond to the annual decreases. This official also noted that such issues are up to each of the five governments to address as they see fit.

In addition, the FSM has no strategic plan to shift basic government operations expenditures from the public sector capacity building grant to local revenues. Although the FSM, according to the terms of a grant condition, provided OIA with a document that calculates percentage decreases of these expenditures from the grant through 2009, there is no additional plan describing the policy steps that will be taken or the agencies and activities that will be affected. Funding for this grant began decreasing in fiscal year 2005, and some officials have expressed concern over the consequences of reduced compact funding to support routine government activities.

Trust Funds Have Earned Low Returns

The FSM and RMI trust funds are earning low returns on trust fund contributions, raising concerns about the future adequacy of the trust funds to ultimately replace grant assistance. All trust fund contributions are currently in commercial bank accounts earning up to 2.63 percent in interest, because neither trust fund has been placed with an investment advisor that will work to maximize returns. According to an OIA official, this circumstance has resulted from the time it took the FSM and the RMI to approve the amended compacts as well as the process involved in

selecting an investment advisor and placing funds with money managers. In February 2005, the RMI trust fund committee selected a trust fund investment advisor; no advisor has been selected for the FSM as of mid-May 2005, although the process to select one is under way.

This situation is important in the context of our prior analysis that raised questions about the sufficiency of the trust funds to generate earnings that could replace compact grants beginning in 2024.²⁸ For example, assuming an annual return of 7.9 percent realized by the trust funds at the beginning of fiscal year 2004, we projected that the FSM trust fund earnings by 2048 would be inadequate.²⁹ However, future earnings in excess of 7.9 percent could counterbalance the slow start for the trust funds. The FSM appears to be in a weaker position relative to the RMI, in that it has not selected a trust fund investment advisor and has not yet obtained additional contributions from other donors.

Regarding a separate trust fund issue, U.S. membership in the FSM and RMI trust committees is not yet aligned with language contained in the amended compacts' enabling legislation, which states that it is the sense of the U.S. Congress that U.S. appointees to the trust fund committees "should be designated from the Department of State, the Department of the Interior, and the Department of the Treasury." Current U.S. government trust fund committee participants are from the same U.S. agencies that participate in the JEMCO and JEMFAC: the Departments of the Interior, State, and Health and Human Services. An OIA official noted that an effort is under way to eventually include the Department of the Treasury as an additional member of the RMI trust fund committee when Taiwan contributes to the RMI trust fund and can become a member of the committee. (The trust fund agreements allow additional donors to become members of the committees but also require a U.S. majority vote in trust fund committees; therefore, the U.S. government will add another member if Taiwan joins the RMI trust fund committee.)

²⁸See GAO, *Compact of Free Association: An Assessment of the Amended Compacts and Related Agreements*, [GAO-03-1007T](#) (Washington, D.C.: July 15, 2003).

²⁹A 7.9 percent rate of return is based on trust funds that are comprised of both stocks (60 percent of the portfolio) and long-term government bonds (40 percent of the portfolio).

United States, FSM, and RMI Have Taken Actions to Meet Key Accountability Requirements, Though a Few Requirements Remain Uncompleted

The U.S., FSM and RMI governments have taken several actions to fulfill key accountability requirements, such as meeting annually to approve grants, establishing special grant terms and conditions, and preparing various reports. Further, the U.S. government has withheld grant funding for noncompliance with compact and grant requirements and initiated an investigation into the possible misuse of compact funds in the FSM state of Chuuk. However, a few important requirements, such as the preparation of annual compact spending and development reports, remain uncompleted. (See app. III for a table listing requirements that have and have not been met.)

Most Required Meetings and Consultations Have Occurred

In August 2003 and 2004, the U.S. government held bilateral meetings with the FSM through JEMCO and with the RMI through JEMFAC to discuss and approve fiscal year sector grants allocations. The minutes for the August 2004 JEMCO and JEMFAC meetings showed a discussion of committee procedures and approval of specific sector grant levels.³⁰ JEMCO and JEMFAC have focused on grant approval and performance assessment, while other committee duties, such as reviewing other donor assistance or audit findings, have received limited attention. Although the JEMFAC meetings with RMI reached consensus on grant issues, the JEMCO meetings with the FSM showed areas of strong disagreement between the U.S. and FSM representatives; these disagreements were decided by a vote, split between the countries, that adopted the U.S. position.³¹ The FSM government sent a letter to the U.S. government expressing frustration over the 2004 JEMCO meeting and the manner in which decisions were reached. Special meetings can be called by three JEMCO or two JEMFAC members. A special bilateral meeting with the FSM was held in Honolulu on March 11, 2005, to discuss grant management problems regarding one of the FSM subgrantees, Chuuk state, and a special JEMCO meeting was held that

³⁰Subsequent to JEMFAC approval of grant allocations, the RMI's legislative body (the Nitijela) altered the allocations between health, education, and infrastructure. The JEMFAC then conducted e-mail communication to approve these alterations.

³¹For example, the FSM delegation strongly advocated the use of compact funds for land leases and purchases but was overruled by the U.S. representatives. The U.S. position is that compact funding should not go to lease or purchase land when ownership is often unclear and property value has not been established. This issue remains key for the FSM, and FSM officials told us they intend to continue raising this topic with U.S. officials. A senior Interior official told us that if the FSM can resolve ownership and valuation problems, compact funding could potentially be used for land lease or purchase.

same day to reach decisions regarding the FSM infrastructure development plan and the use of fiscal year 2004 carry-over funds.

In addition, the amended compacts require budget consultation meetings before the compact budgets are submitted and the formal JEMCO and JEMFAC meetings are held. These consultations were held with the FSM before the 2005 JEMCO meeting. However, no consultations were held with the RMI because that government was late in providing a draft budget to the U.S. government; a budget was not provided until 1 week before the JEMFAC meeting. Budget consultations were held with both countries in 2003 in preparation for fiscal year 2004.

Special Grant Conditions Have Been Established

JEMCO and JEMFAC specified additional accountability requirements by including special terms and conditions that were included in the fiscal year 2004 and 2005 individual grants agreements. These special terms and conditions ranged widely, from requiring information on the three FSM health insurance programs to requiring that both countries submit appropriate environmental performance measures and baseline data for approved activities to OIA.

According to OIA officials, the RMI met most of the special grant terms and conditions attached to the country's grants; however, the FSM met only some of its specific terms and conditions. For example, according to OIA staff, the FSM has had difficulty identifying useful performance baseline data for most sectors because of information disorganization and fragmentation. OIA officials reported that the FSM was unable to satisfy more conditions because of a lack of skilled staff in all four FSM states and the national government. They stated that the staff members with responsibility for sector grant compliance did not always have the requisite level of understanding or skill to make sure that problems were being addressed.

Key Reports Have Been Prepared

The FSM and the RMI have submitted their annual compact budgets to the U.S. government, as well as all quarterly financial and performance status reports, and annual financial reports. OIA has asked for FSM to revise its budgets to include more specific data, such as the number of people working on a particular program. OIA officials have found the FSM's 2004 quarterly financial and performance reports to be in need of improvement, while such reports from the RMI were viewed as adequate. A senior HHS official noted that the FSM has had significant difficulty in providing

standardized performance data between the states that can be compared. FSM officials told us that the national government does not assess the quarterly performance reports prepared by the five governments and simply compiles them for transmission to OIA. Both countries have submitted financial and performance reports to the U.S. government on time, and Pohnpei and Chuuk states have withheld pay for officials responsible for performance reports that were not provided on time to the FSM national government.

OIA has been working with the FSM to improve and standardize the FSM's performance reporting format; and, as of the first quarter of fiscal year 2005, all FSM governments were using a uniform reporting format that was approved by OIA. Officials in both countries told us that the requirement to produce performance reports was a positive step and would help to create a linkage between expenditures and their impact. However, the officials acknowledged that they are still in the process of learning how to generate such reports, and that, although the reports have the potential to be used as a management tool, the governments are not yet able to use the reports in this capacity.

Interior Has Withheld FSM Grants and Initiated a Misuse Investigation

In several instances, the U.S. government has not provided compact funds to the FSM or RMI in order to ensure compliance with compact requirements, and accountability over sector grants. In two instances, OIA withheld compact funding from the FSM when the country was slow to meet grant conditions. Further, OIA suspended FSM funding due to possible misuse in another situation. Finally, in an effort to ensure prudent financial operations, OIA has delayed providing FSM and RMI grant funding due to cash management concerns. A Department of State official noted that the FSM and RMI governments are definitely taking note as the U.S. government makes use of this new tool to ensure the appropriate use of compact funding.

In the first instance, in approving FSM use of most of its public sector capacity-building grant funds for basic government operations rather than for the principal compact objectives for this sector, as mentioned earlier, JEMCO also adopted a grant condition for the fiscal year 2004 public sector capacity building grant. This condition required a "transition plan" by March 2004 explaining how these expenses would be removed from this grant. When the FSM did not provide such a plan, OIA withheld FSM public sector capacity-building grant funding, totaling approximately \$1.9 million in May and June 2004 combined. After the FSM provided the plan to the

U.S. government in July, OIA released the funding.³² The second, similar instance occurred simultaneously with a much smaller grant. JEMCO attached a special grant condition to the FSM's private sector development grant, requiring that the FSM provide a 5-year transition plan for shifting basic government operating costs away from this grant to local revenues. When the FSM did not provide the plan on time, OIA withheld about \$630,000 of sector funding in May and June 2004 until the FSM provided a plan in June 2004.

Further, as of March 2005, OIA suspended the Chuuk education grant's meal service program funding, because of questions surrounding the delivery of meals to students. The program was allocated almost \$1 million in fiscal year 2005. Because OIA staff were unable to verify that food purchased by the program was received by the Chuuk Education Department or served to students, OIA has suspended—following a bilateral meeting that addressed this issue—\$80,380 each month until the FSM national government reports on corrective actions to ensure that the meal service program operates effectively. As of May 2005, this issue, which was uncovered during a field visit to Chuuk by an OIA Honolulu office employee, had not been resolved. OIA also contacted Interior's Office of the Inspector General for a follow-up investigation to determine whether Chuuk is misusing compact grant funds.³³ According to a senior OIA official, the FSM national government is cooperating with this investigation.

Finally, OIA took action in response to FSM and RMI cash management issues (an area not directly related to fulfillment of grant conditions or misuse of funds). OIA delayed payments to the FSM and the RMI in August 2004, when the required third-quarter cash transactions report showed that both countries had notable excess grant sector funding that had not been spent. OIA subsequently resumed funding when the governments reported that they needed cash to meet their obligations. OIA also stopped payments to the FSM in May 2005 when an OIA review showed that the FSM had

³²The impact of this action is unclear. For example, according to a Chuuk state finance official, the Chuuk government used a portion of the state's trust fund contributions (which were not yet required to be submitted for the FSM trust fund) to replace withheld public sector capacity building funds, and then replaced the trust fund amounts when the public sector capacity building grant was eventually provided.

³³Interior's Office of the Inspector General has conducted audit reviews of FSM and RMI implementation of the amended compacts.

about \$9.7 million in cash on hand. Compact payments will be delayed until the FSM demonstrates its need for additional funding.

A Few Important Requirements Remain Uncompleted

Despite progress in many areas, a few important accountability reporting requirements have not been met, preventing the U.S., FSM, and RMI governments from fully gauging FSM and RMI performance in utilizing compact funds and from beginning to assess the impact of compact funding.

- Required broad annual reports summarizing compact spending and progress in meeting development goals have not been completed by any of the three governments. The U.S. government has not provided its fiscal year 2004 report from the President to the U.S. Congress, due in December 2004, though a draft is being circulated for interagency approval. Similarly, the FSM and the RMI have not submitted fiscal year 2004 reports to the U.S. President, although they were due in February 2005.³⁴
- Key development planning efforts remain incomplete, as mentioned in the previous section. These plans were due no later than 90 days after the amended compacts went into effect. The FSM has prepared a development plan, and the FSM Congress approved transmittal of this plan to the U.S. government in May 2005. JEMCO has not yet considered the plan. The RMI has provided the U.S. government with a required medium-term budget and investment framework, as well as a policy framework paper and annual plans for each sector, but it is unclear whether the JEMFAC has approved RMI planning documentation addressing the use of grant funds. OIA officials have provided contradictory views; while one senior official reported that the RMI's approach was approved during the 2003 bilateral meeting, another official disagreed, and no record exists to document this meeting. No subsequent action has been taken to approve the RMI's planning efforts. A senior OIA official noted that this particular issue has not received the attention it requires.

³⁴The FSM government asked OIA for an extension of this deadline; OIA declined to allow such an extension. According to an OIA official, the RMI government has not asked for an extension.

Required audits that OIA intends to use to gauge compact compliance in specific areas such as procurement, remain outstanding or have been late. Single audits for fiscal year 2004 were due on April 1, 2005. The FSM has not completed its fiscal year 2004 single audit.³⁵ The RMI has been late in meeting this requirement; the RMI completed its fiscal year 2004 single audit in June 2005.³⁶

OIA Opened New Office in 2003, FSM and RMI Took Steps in 2005 to Establish Centralized Compact Offices

In October 2003, OIA took a significant step toward facilitating implementation and oversight of the amended compacts by opening a Honolulu field office to manage compact issues. However, OIA has not conducted a review to determine the extent of oversight of compact activities in the FSM and the RMI that would adequately promote compliance with compact requirements, though officials from all three governments told us that OIA staff should be spending more time in the two countries. Staff are currently spending about 15 percent of their time in the two countries. The FSM and the RMI governments have subsequently acted to create or identify central offices responsible for compact matters. The RMI government is progressing more quickly than the FSM government in this regard, and it has also taken other actions to facilitate compact implementation, such as creating an infrastructure project management unit.

OIA Opened a Honolulu Field Office to Facilitate Compact Implementation and Monitoring, but Extent of Required On-Site Review Has Not Been Established

In October 2003, OIA opened a new Honolulu field office specifically intended to facilitate implementation and oversight of the amended compacts, although OIA has not determined how much on-site review of compact activities in the FSM and the RMI is necessary. During the congressional approval process for the amended compacts in 2003, in addressing why OIA should open an office in Honolulu rather than placing OIA staff in the FSM and the RMI, the Deputy Assistant Secretary for Insular Affairs reported to the House Committee on International Relations, Subcommittee on Asia and the Pacific, that “The Honolulu team

³⁵In addition, the FSM has not completed its fiscal year 2003 single audit.

³⁶Prior to completion of the single audit, the RMI Auditor General told us that a preliminary review of the draft fiscal year 2004 single audit showed that the amended compact is resulting in the emergence of more compliance issues. For example, more procurement problems are cited now due to the new fiscal procedures agreement requirements in this area.

will be able to travel frequently to the [FSM and the RMI]. While travel costs are high from Honolulu, additional travel costs are offset by not having to supply permanent housing, post differential, home leave, and education for dependents that come with foreign posts.” The office has five professional staff—specialists in health, education, infrastructure, private sector development, the environment, and financial management—that provide program and financial expertise along with a knowledge and understanding of the region, and work with the OIA Compact Coordinator in Washington, D.C.³⁷ The Honolulu staff perform activities such as analyzing FSM and RMI budgets and other required reports, traveling to the islands to discuss and review expenditures and performance with FSM and RMI government officials and conduct site visits, providing briefings and advice to OIA and State officials regarding progress and problems, and providing support for bilateral meetings.³⁸

However, in conjunction with establishing the Honolulu office, OIA did not determine the extent of on-site review of compact activities in the FSM and the RMI that would adequately promote compliance with compact and grant requirements. OIA fieldwork in the FSM and the RMI is necessary to ensure accountability over funds and compliance with compact and grant requirements, and is one of the principle reasons why the office was established in Honolulu. According to a cable from the U.S. Ambassador to the FSM “The constant flow of compact-related queries highlights the need for continued, intensive hands-on [OIA] involvement... [E]ffective oversight by Interior’s staff in Hawaii will be critical in realizing the compact’s full potential... [OIA] staff will need to meet regularly with [FSM] state officials from both the executive branch and the legislatures. Working more closely with state officials as they develop their budgets would enable [OIA] staff to spot and resolve problems well before budgets are finalized... Oversight by e-mail is not an option.”

Officials from all three countries told us that while they view the creation of OIA’s Honolulu office as a positive development, they believe that the Honolulu staff should spend more time in the FSM and the RMI than they

³⁷One specialist works on both private sector development and environment issues. In addition, the Honolulu office has one administrative employee.

³⁸Prior to opening the Honolulu office, OIA had a program coordinator stationed in the FSM, and in July 2004, OIA hired a program specialist who is stationed in the RMI. OIA staff at the U.S. embassies in the FSM and the RMI provide direct contact with the local and national governments and assist the Honolulu staff as needed.

currently do, to provide additional guidance on meeting compact requirements and conduct site visits. For example:

- The Deputy Assistant Secretary for Insular Affairs told us that he is not satisfied with the amount of on-site review that his staff is able to conduct but that his office must deal with the budget available to it. The OIA Compact Coordinator and staff from the Honolulu office report that on-site time in the field is inadequate and does not allow for detailed reviews of federal funds in the various remote islands.
- The U.S. Ambassadors to the FSM and the RMI both told us that OIA Honolulu staff should have the resources to conduct more work in the two countries. For example, more on-site work by OIA staff with country budget and finance issues is needed, as well as sufficient time to conduct site visits to schools.
- The HHS official that participates in the JEMCO and the JEMFAC noted the value of OIA on-site review in Chuuk and said that there needs to be more on-the-ground work.
- FSM and RMI officials also noted a need for additional on-site review and inspection by OIA staff, including site visits to schools in Pohnpei and infrastructure projects that are under way in the RMI.

For fiscal year 2005, the OIA Honolulu office has a travel budget of \$170,000, and for fiscal years 2004 and 2005 (through mid-April), staff in OIA's Honolulu office spent about 15 percent of their total work time reviewing compact-related activities in the islands. OIA officials report that they are allocating their travel based on available funds for travel, while the OIA Honolulu office reports that they have had no input into the preparation of OIA's budget or the allotment process. Examples of the impact of on-site review include the previously mentioned visit to Chuuk state by OIA Honolulu staff that uncovered possible misuse, as well as meetings OIA program specialists have held in the islands to discuss key issues, such as standardizing and improving both financial and performance measurement reporting, with FSM and RMI officials. According to OIA officials, the office has no assessment under way to establish if this amount of time spent in the FSM and the RMI meets oversight needs. While OIA officials believe the funding for on-site review is insufficient, the department has not supported increased funds for this purpose.

FSM and RMI Governments Have Taken Initial Steps to Create Central Compact Offices

Both the FSM and the RMI are seeking to centralize their government contact with the U.S. government and provide for day-to-day management of grant operations, as required in the FPAs. Although the RMI is making more rapid progress than the FSM in this area, both countries are in the early stages of establishing centralized offices responsible for compact matters.

- In early 2005, the RMI government identified the Office of the Chief Secretary as the official point of contact for all communication and correspondence between the U.S. government and the RMI government concerning compact sector grant assistance. The Chief Secretary is the head of RMI public service and will coordinate and direct the various ministries receiving compact funding with respect to the FPA and compact provisions. The Chief Secretary will also work closely with the RMI Economic Policy, Planning, and Statistics Office to develop the annual budget and sector portfolios and quarterly and annual monitoring and evaluation reports. While the Office of the Chief Secretary will provide oversight and coordination, the Chief Secretary has reported that most of the daily activities and compliance will be conducted by the ministries themselves. The Chief Secretary has outlined his plan to coordinate with agencies and reported to us that he will hold weekly meetings with all secretaries to address compact implementation issues, review reports on specific issues, and provide guidance to the ministries and agencies of the RMI government on compact matters.
- The FSM Congress recently enacted legislation to establish a Compact Management Board and a supporting Office of Compact Management. The board will consist of seven members; the FSM President will appoint two members, each state will appoint one member, and the final member will be the head of the Office of Compact Management. Whereas the board will be responsible for actions such as formulating JEMCO guidelines for FSM members, the compact office will be responsible for daily communications with JEMCO and the United States with regard to JEMCO and compact matters. A senior FSM official told us that although he expects compact office staff to undertake actions such as compliance visits to the FSM states, he does not expect the constitution of the board to be completed and the office

ready to function until October 2005.³⁹ Although there are ongoing differences between the FSM executive and legislative branches over which branch the compact office should be accountable to, the FSM Congress appropriated \$100,000 in 2005 for the operation of the board.⁴⁰

Although both countries have taken steps to provide for a centralized approach to addressing compact implementation and day-to-day management of grant operations, neither government's efforts in this important area are yet under way, and the ultimate effectiveness of such efforts is unknown. The FPAs state that the FSM and RMI are responsible for the management and monitoring of the day-to-day operations of all sector grants to ensure compliance with all applicable grant terms and conditions; however, officials from both countries told us that this issue had not received much attention. Further, a senior FSM government official told us that the national government is not monitoring the day-to-day implementation of the compact by the states.⁴¹ Notably, a senior OIA official emphasized that the FSM's and the RMI's partnership with OIA in monitoring compact implementation is key to the success of the amended compacts.

The RMI has also made more rapid progress than the FSM in managing implementation of its infrastructure grant. The RMI government hired a foreign firm to be the project management unit that designs and oversees individual infrastructure projects and work is under way. Following an extensive survey to assess the state of RMI education and health infrastructure and determine priority infrastructure projects, several

³⁹Since the creation of the board and its office has been slow to start, the FSM government established in the meantime a Compact Implementation Taskforce in 2003. The task force is overseen by the vice president and composed of cabinet members and discusses and follows up on compact-related issues and reporting requirements. The task force will continue in its role until the Compact Management Board and its office becomes operational. According to a FSM Department of Foreign Affairs official, the task force has met as needed, which has averaged about once a month, and developed a performance-tracking matrix that lists implementation issues and actions taken.

⁴⁰Some FSM national and U.S. government officials have expressed concern to us that the compact management board and its office may reduce the role of the FSM president in managing grant matters and conducting international affairs.

⁴¹The FSM national government is the grantee of the compact funds and is responsible for ensuring compact compliance by the four state governments, or subgrantees, that receive the majority of Compact funds.

contracts have been awarded, for example, for the construction and maintenance of schools and a hospital. The FSM just established a project management unit in June 2005. Per a JEMCO resolution, such a unit must be established in order to receive infrastructure grant funds.

In addition, the FSM and RMI are each working to improve their accounting software systems. The RMI government has adopted a new accounting software system that meets with OIA's approval and is currently being reviewed within the RMI to ensure that it allows for compliance with compact FPA requirements. Further, the RMI Ministry of Finance has hired fixed-asset and procurement specialists and established a satellite office in Ebeye to handle the specific needs of that area. The FSM, which currently has three different accounting software programs spread among the four states and the national government, is in the process of purchasing a unified accounting system. It will install the program and train each government's personnel to satisfy compact reporting requirements.

Conclusions

The amended compacts differ significantly from the original compact in that they target funding to identified priority areas; require grant agreements; substantially increase accountability requirements to include new dimensions, such as performance measurement; and allow for the withholding of funds for noncompliance with compact or grant requirements. Diligent and sustained effort by the U.S., FSM, and RMI governments will be required to adapt fully to this new approach for providing and accounting for U.S. economic assistance to the FSM and the RMI.

Within this new environment, all three countries have demonstrated a commitment to meeting new compact funding and accountability requirements. The U.S. government has undertaken notable actions during the early stages of compact implementation that reflect its commitment. It has embraced new accountability options in the amended compacts by, for example, requiring data that will facilitate performance measurement and suspending funds as a result of possible misuse. Further, by holding infrastructure funding until the countries provide sufficient infrastructure project and identification management, the U.S. government has taken a new approach to ensuring the effective use of compact funds. In addition, by establishing a Honolulu field office and investing in staff to provide monitoring and oversight, OIA has demonstrated its commitment to successful implementation of the amended compacts. Such staff are critical to conducting work in the field to monitor performance and

financial accountability, as OIA's review of education expenditures in the FSM state of Chuuk has demonstrated. However, officials from all three governments believe that more OIA field work is in order. OIA needs to determine the extent of on-site work in the FSM and the RMI necessary to adequately promote compliance with amended compact and grant requirements.

The FSM and the RMI have also acted to meet compact requirements, although many of these actions are in an early stage. Both countries have taken steps to establish centralized offices responsible for ensuring compact implementation and day-to-day oversight; however, it is too early to assess how well these offices will meet this goal. Further, both countries have responded in a positive fashion to many new reporting requirements. For example, the FSM and the RMI expressed a desire to provide useful performance reports and have been responsive to working with OIA to strengthen and improve this new approach to accounting for compact funds. In addition, both countries have been timely in providing quarterly financial and performance reports. While both countries are moving to meet compact requirements, to date the RMI is progressing more quickly than the FSM in spending authorized grant funding, meeting special grant conditions, preparing adequate required reports, taking steps to centralize compact management, and selecting an investment advisor who can work to maximize trust fund returns.

Although the three governments' commitment to meeting compact requirements is clear, challenges for future performance exist. The failure of all three governments to complete required annual compact spending and development reports means that, for the first year under the amended compacts, there is no assessment of the use of U.S. assistance and initial performance in key areas such as health and education. Similarly, the lack of timely single audits deprives the United States of a key source of information on the FSM's and the RMI's compliance with detailed compact requirements. Additionally, the FSM's difficulties in preparing a national infrastructure development plan to obtain substantial infrastructure grant funding demonstrate the difficulty the country is having integrating state and national priorities and using compact funds to advance national goals. Finally, it is unclear why strategic issues, such as the need for planning to use compact funds to achieve long-term economic advancement or to address annual grant decreases, are not being actively considered by all three governments, regardless of the early stage of the amended compacts' implementation. The U.S. government has not pursued resolution of these

issues, which have implications for the FSM's and the RMI's long-term, effective use of funds.

Recommendations

To effectively use Interior staff resources and to maximize the effectiveness of U.S. monitoring of compact expenditures, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs to determine, relative to other office responsibilities, the extent of OIA on-site review in the FSM and the RMI of compact activities that is required in order to adequately promote compliance with compact and grant requirements.

To improve grant administration and oversight and to facilitate planning for the effective use of compact funding, we recommend that the Secretary direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the Joint Economic Management Committee, in coordination with other U.S. agencies that participate in this committee, to work with the FSM government to take the following four actions:

- establish sector grant levels for each of the five governments that are consistent with national priorities and will assist in promoting long-term development goals such as economic advancement and budgetary self-reliance,
- establish a time frame for the completion of required and overdue FSM single audits,
- establish a time frame for the completion of FSM government plans to manage decreasing annual grant amounts and to shift basic government operations under the public sector capacity building to local revenues in a strategic fashion, and
- outline specific actions that the FSM government will take in managing and monitoring day-to-day sector grant operations to ensure compliance with all grant terms and conditions.

To improve grant administration and oversight and to facilitate planning for the effective use of compact funding, we recommend that the Secretary direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of the Joint Economic Management and Financial Accountability Committee, in coordination with other U.S. agencies that participate in this committee, to work with the RMI government to take the following three actions:

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- establish sector grant levels that will assist in promoting long-term development goals such as economic advancement and budgetary self-reliance,
 - establish a time frame for the completion of an RMI government plan to manage decreasing annual grant amounts in a strategic fashion, and
 - outline specific actions that the RMI government will take in managing and monitoring of day-to-day sector grant operations to ensure compliance with all grant terms and conditions.

Agency Comments

We received technical comments from the Departments of the Interior, State, and HHS, as well as the FSM and RMI governments. The RMI submitted particularly extensive technical comments that stressed, among other things, that government's detailed strategic planning efforts and provided suggestions to improve the factual accuracy of this report. We incorporated technical comments into our report, as appropriate. We also received formal comment letters from all parties. All letters found our work to be useful, although the RMI remarked that the report overstated long-term strategic planning issues, provided insufficient emphasis on economic components of the amended compact that have not been fully implemented, and included passages that were in need of factual correction. The Department of the Interior concurred with our recommendations and stated its intention to implement them. State, HHS, and the FSM government did not comment on our recommendations to Interior. The RMI government stated that some of the recommendations did not reflect the purpose or intent of the amended compact.

In addition to providing copies of this report to your offices, we will send copies of this report to other appropriate committees. We will also provide copies to the Secretaries of the Interior, State, and Health and Human Services, as well as the President of the Federated States of Micronesia and the President of the Republic of the Marshall Islands. We will make copies available to other interested parties upon request.

If you or your staff have any questions regarding this report, please contact me at (202) 512-4128 or gootnickd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix IX.

A handwritten signature in black ink that reads "David Gootnick". The signature is written in a cursive style with a large, looping initial "D".

David Gootnick
Director, International Affairs and Trade

Objectives, Scope, and Methodology

The Chairman and Ranking Minority Member of the House Committee on Resources, and the Chairman and Ranking Minority Member of the Senate Committee on Energy and Natural Resources requested that we report on the progress of initial efforts to implement the amended compacts. This report evaluates actions taken by the United States, Federated States of Micronesia, and the Republic of the Marshall Islands governments since fiscal year 2004 to (1) meet funding requirements and plan for the use of this funding, (2) meet accountability requirements, and (3) establish operations to facilitate compliance with funding and accountability requirements.

To identify actions taken by the three governments to meet funding requirements, we reviewed the amended compacts as well as the subsidiary fiscal procedures agreements and subsidiary trust fund agreements to identify such requirements as well as expectations of the U.S. Congress in this area. We reviewed all fiscal year 2004 and 2005 grant agreements with both countries, including special terms and conditions included in these agreements, and identified instances where no grant agreement had been signed. We examined annual financial data prepared by the FSM and the RMI to determine the amount of funding that was not spent for fiscal year 2004 and what sectors were affected by this circumstance. We discussed the FSM and RMI data with an Office of Insular Affairs official who has used this information, and determined that the data are sufficiently reliable for the purposes of our report. We also corroborated our calculations of unspent funds with this official. We did not review funding provided to Kwajalein landowners in exchange for U.S. military access to Kwajalein Atoll. This funding is for landowner use and is not included as part of U.S. economic assistance that is subject to sector grants and accountability requirements.

To identify issues that impact planning for the use of compact funds, we discussed planning efforts with U.S., FSM, and RMI government officials and also identified issues through our own analysis (such as the use of the distribution formula in the FSM). We then reviewed such issues by examining documents such as FSM and RMI legislation and documentation provided to the U.S. government (such as the FSM's transition plan to shift ineligible spending under the public sector capacity building grant to local revenues). To identify FSM education spending per capita, we used FSM education grant data and divided grant amounts provided to each state by the student population for each state—the latter data were provided to us by OIA, which received them directly from the FSM. To identify FSM health spending per capita, we assessed health grant amounts against FSM

population data. We determined that these data were sufficiently reliable for the purposes of our report.

To identify actions taken by the three governments to meet accountability requirements, we reviewed the amended compacts as well as the subsidiary FPAs to identify such requirements. We also reviewed the briefing documents created by the U.S. government in preparation for the annual bilateral meetings with the two countries, as well as the minutes and resolutions, when available, related to the meetings. We further reviewed FSM and RMI documents—such as budget justifications and portfolios, quarterly financial forms and performance reports, and annual financial reports—submitted by the FSM and RMI governments to the U.S. government to confirm compliance with accountability reporting requirements. We discussed the sufficiency of such reports with OIA officials. We also examined FSM and RMI laws and letters exchanged between the FSM and U.S. governments.

To identify actions the three governments have taken to establish operations to facilitate compliance with funding and accountability requirements, we reviewed the amended compacts and FPAs to identify specific monitoring responsibilities. In the case of the OIA Honolulu office, we reviewed senior management statements regarding the purpose and function of this office and job descriptions for all staff. To identify the extent of Honolulu office staff travel to the FSM and the RMI, we obtained the travel records and start dates of all five program specialists and discussed this information with OIA officials to ensure that the data was sufficiently reliable for our use. We calculated the percentage of time spent conducting on-site review in the two countries over fiscal years 2004 and 2005 (through mid-April) time span and compared this to the total work time for the program specialists. We obtained OIA travel budget data for the Honolulu office from OIA officials. We reviewed FSM and RMI laws that address structural changes to compact management, as well as unclassified cables from the Department of State.

To address all objectives, we held extensive interviews with officials from the U.S. Department of the Interior (Washington, D.C., Honolulu, Hawaii, the FSM, and the RMI) and the Department of State (Washington, D.C., the FSM, and the RMI). We also interviewed officials from the U.S. Department of Health and Human Services (Washington, D.C., and Honolulu, Hawaii). We traveled to the FSM (Pohnpei and Chuuk) and the RMI (Majuro and Ebeye). We had detailed discussions with FSM (national, Pohnpei, and Chuuk governments) and RMI officials from foreign affairs, finance,

budget, health, education, public works, and audit agencies. Further, we met with the presidents of the FSM and the RMI. We also met with officials from the U.S. Army Kwajalein Atoll to discuss compact implementation issues. We met with representatives from private sector businesses within the Marshall Islands and with leaders from the Micronesian Seminar, a nonprofit organization in Pohnpei, FSM that provides public education on current FSM events, to obtain their views on compact implementation and development issues. We also met with officials from the Interior Inspector General's Office (Guam, Honolulu, Hawaii, and Washington, D.C.) to discuss ongoing investigations in the FSM and RMI.

We conducted our review from August 2004 through May 2005 in accordance with generally accepted U.S. government auditing standards. We requested written comments on a draft of this report from the Departments of the Interior, State and Health and Human Services, as well as the governments of the FSM and RMI. All comments are discussed in the report and are reprinted in appendixes IV through VIII. Further, we considered all comments and made changes to the report, as appropriate.

Country Sector Grants, Fiscal Years 2004 and 2005

Table 3: FSM Sector Grant Allocations between the Five Governments, Fiscal Years 2004 and 2005

Sector grant and recipient	Fiscal year 2004		Fiscal year 2005	
	Sector grant dollar amount	Percentage of total sector grants	Sector grant dollar amount	Percentage of total sector grants
Education grant				
FSM National Government	4,324,122	17	4,511,317	17
Chuuk	8,140,265	31	8,804,369	32
Pohnpei	7,373,651	28	7,469,772	28
Yap	4,243,681	16	4,249,157	16
Kosrae	1,883,853	7	2,070,432	8
Total	\$25,965,572	100	\$27,105,047	100
Health grant				
FSM National Government	553,613	4	763,235	4
Chuuk	4,691,707	30	5,595,636	32
Pohnpei	5,989,461	39	6,200,560	36
Yap	2,881,672	19	3,197,090	18
Kosrae	1,326,663	9	1,674,212	10
Total	\$15,443,116	100	\$17,430,733	100
Infrastructure grant				
Total	\$17,119,115	100	\$17,249,121	100
Public sector capacity building grant				
FSM National Government	4,287,697	37	608,028	8
Chuuk	2,853,813	24	3,001,410	39
Pohnpei	1,676,163	14	1,542,488	20
Yap	1,831,307	16	1,520,446	20
Kosrae	1,013,866	9	1,113,866	14
Total	\$11,662,846	100	\$7,786,238	100

Appendix II
Country Sector Grants, Fiscal Years 2004 and 2005

(Continued From Previous Page)

Sector grant and recipient	Fiscal year 2004		Fiscal year 2005	
	Sector grant dollar amount	Percentage of total sector grants	Sector grant dollar amount	Percentage of total sector grants
Environment grant				
FSM National Government	79,477	4	111,421	5
Chuuk	378,394	19	502,499	21
Pohnpei	666,944	33	688,181	29
Yap	595,854	29	791,258	33
Kosrae	302,523	15	296,592	12
Total	\$2,023,192	100	\$2,389,951	100
Private sector grant				
FSM National Government	513,091	14	0	0
Chuuk	1,338,874	35	1,403,876	35
Pohnpei	525,423	14	657,602	16
Yap	613,470	16	989,407	24
Kosrae	795,261	21	988,025	24
Total	\$3,786,119	100	\$4,038,910	100
Total sector grants	\$75,999,960		\$76,000,000	

Source: FSM fiscal years 2004 and 2005 sector grant agreements, discussion with an OIA official.

Notes:

Percentages may not add to 100 due to rounding.

While the authorized amount for FSM fiscal year 2004 grants was \$76,000,000, the actual grants total is \$40 smaller than this amount.

Since infrastructure grants for fiscal years 2004 and 2005 have not yet been allocated to specific projects, the total can not be allocated by recipient.

While authorized grant amounts total \$76.2 million, per the amended compacts' enabling legislation, \$200,000 is provided directly to the U.S. Department of Homeland Security, Federal Emergency Management Agency for disaster and emergency assistance purposes.

The FSM government did not add a partial inflation adjustment of \$1,117,200 into its fiscal year 2005 sector grants; this adjustment will be added to fiscal year 2006 sector grant funding.

The FSM national government supports the College of Micronesia, which has campuses in all four states, with its compact education grant. For example, in fiscal year 2005, the FSM national government budgeted over \$3.8 million of its compact education grant for use by the college.

Appendix II
Country Sector Grants, Fiscal Years 2004 and 2005

Table 4: FSM Grants by Sector, Fiscal Years 2004 and 2005

Sector grant and recipient	Fiscal year 2004		Fiscal year 2005	
	Sector grant dollar amount	Percentage of total sector grant	Sector grant dollar amount	Percentage of total sector grant
Education grant	\$25,965,572	34	\$27,105,047	36
Health grant	\$15,443,116	20	\$17,430,733	23
Infrastructure grant	\$17,119,115	23	\$17,249,121	23
Public sector capacity building grant	\$11,662,846	15	\$7,786,238	10
Environment grant	\$2,023,192	3	\$2,389,951	3
Private sector grant	\$3,786,119	5	\$4,038,910	5
Total sector grants	\$75,999,960	100	\$76,000,000	100

Source: FSM fiscal years 2004 and 2005 sector grant agreements, discussion with an OIA official.

Notes:

While the authorized amount for FSM fiscal year 2004 grants was \$76,000,000 the actual grants total is \$40 smaller than this amount.

While authorized grant amounts total \$76.2 million, per the amended compacts' enabling legislation, \$200,000 is provided directly to the U.S. Department of Homeland Security, Federal Emergency Management Agency for disaster and emergency assistance purposes.

The FSM government did not add a partial inflation adjustment of \$1,117,200 into its fiscal year 2005 sector grants; this adjustment will be added to fiscal year 2006 sector grant funding.

Appendix II
Country Sector Grants, Fiscal Years 2004 and 2005

Table 5: RMI Sector Grants, Including Kwajalein Funding, Fiscal Years 2004 and 2005

Sector grant	Fiscal year 2004		Fiscal year 2005	
	Sector grant dollar amount	Percentage of total sector grant	Sector grant dollar amount	Percentage of total sector grant
Education grant				
Total	\$10,748,932	100	\$11,566,921	100
Portion provided to Kwajalein	1,100,000	10	1,600,000	14
Health grant				
Total	\$6,894,448	100	\$7,064,197	100
Portion provided to Kwajalein	1,000,000	15	1,500,000	21
Infrastructure grant				
Total	\$14,700,000	100	\$13,485,745	100
Portion provided to Kwajalein Atoll	1,000,000	7		
Public sector capacity building grant				
Total	\$0	–	\$103,514	100
Environment grant				
Total	\$400,000	100	\$404,720	100
Portion provided to Kwajalein	200,000	50	202,360	50
Private sector grant				
Total	\$356,620	100	\$361,943	100
Kwajalein impact				
Total	\$1,900,000	100	\$1,922,420	100
Total sector grants	\$35,000,000		\$34,909,460	

Source: RMI fiscal years 2004 and 2005 sector grant agreements, discussions with RMI and OIA officials.

Notes:

While authorized grant amounts total \$35.2 million in fiscal year 2004 and \$34.7 million in fiscal year 2005, per the amended compacts' enabling legislation, \$200,000 is provided directly to the U.S. Department of Homeland Security, Federal Emergency Management Agency for disaster and emergency assistance purposes.

The RMI's fiscal year 2005 education grant was increased from \$11,141,921 (the amount included in the signed grant agreement) to \$11,566,921 by the RMI's legislature. A subsequent e-mail exchange between JEMFAC members approved this increase. There is no signed grant agreement for the final amount.

Appendix II
Country Sector Grants, Fiscal Years 2004 and 2005

A portion of the RMI's fiscal year 2005 infrastructure grant will go to Ebeye for cited projects such as Ebeye elementary school, Ebeye sewer maintenance, and Ebeye water maintenance, though the specific amount for Ebeye is not contained in the grant agreement.

Kwajalein impact refers to funding authorized in section 211(b)(2) of the amended compact between the United States and the RMI.

Table 6: RMI Grants by Sector, Fiscal Years 2004 and 2005

Sector grant	Fiscal year 2004		Fiscal year 2005	
	Sector grant dollar amount	Percentage of total sector grants	Sector grant dollar amount	Percentage of total sector grants
Education grant	\$10,748,932	31	\$11,566,921	33
Health grant	\$6,894,448	20	\$7,064,197	20
Infrastructure grant	\$14,700,000	42	\$13,485,745	39
Public sector capacity building grant	\$0	0	\$103,514	0
Environment grant	\$400,000	1	\$404,720	1
Private sector grant	\$356,620	1	\$361,943	1
Kwajalein impact	\$1,900,000	5	\$1,922,420	6
Total sector grants	\$35,000,000	100	\$34,909,460	100

Source: RMI fiscal years 2004 and 2005 sector grant agreements, fiscal years 2004 and 2005, discussions with RMI and OIA officials.

Notes:

While authorized grant amounts total \$35.2 million, per the amended compacts' enabling legislation, \$200,000 is provided directly to the U.S. Department of Homeland Security, Federal Emergency Management Agency for disaster and emergency assistance purposes.

The RMI's fiscal year 2005 education grant was increased from \$11,141,921 (the amount included in the signed grant agreement) to \$11,566,921 by the RMI's legislature. A subsequent e-mail exchange between JEMFAC members approved this increase. There is no signed grant agreement for the final amount.

Kwajalein impact refers to funding authorized in section 211(b)(2) of the amended compact between the United States and the RMI.

Status of Accountability Requirements, Fiscal Years 2004 and 2005

	FSM		RMI	
	FY 2004	FY 2005	FY 2004	FY 2005
Compact budget by sector grant	Yes	Yes	Yes	Yes
Budget consultations with U.S. government	Yes	Yes	Yes	No
JEMCO/JEMFAC meetings	Yes	Yes	Yes	Yes
Quarterly financial reports	Yes	Yes	Yes	Yes
Quarterly performance reports by sector	Yes	Yes	Yes	Yes
Annual financial reports	Yes	N/A ^a	Yes	N/A ^a
Annual compact report to the U.S. President	No	N/A ^a	No	N/A ^a
Single audit reports	No	N/A ^a	Yes	N/A ^a
Approved FSM Development Plan or Approved RMI Medium-Term and Investment Framework (MTBIF) ^b	No	No ^c	Unknown ^d	Unknown ^d
Approved FSM Infrastructure Development Plan and RMI Infrastructure Development and Maintenance Plan	No ^e	Yes ^e	Yes	N/A ^f

Source: Annual FSM and RMI budgets, required FSM and RMI quarterly and annual reports, JEMCO/JEMFAC minutes, development plan documentation, and interviews with U.S., FSM, and RMI officials.

Note:

N/A = Nonapplicable.

^aThese reports will be due after the end of fiscal year 2005.

^bPortions of the development plan or MTBIF that address the use of grant funds require U.S. concurrence.

^cThe FSM submitted a development plan to the U.S. government in fiscal year 2005; this plan has not yet been considered by JEMCO.

^dMTBIF documents have been prepared, however it is unclear whether the JEMFAC has approved such documentation.

^eAt a special JEMCO meeting in March 2005, JEMCO approved portions of the FSM's infrastructure development plan that contemplate use of compact infrastructure sector funds for fiscal years 2004 and 2005 projects within the priorities established in the FPA.

^fOnce required documentation was submitted and approved, subsequent fiscal year 2005 documentation was not required.

Comments from the Department of the Interior

Note: GAO comment supplementing those in the report text appears at the end of this appendix.



United States Department of the Interior

OFFICE OF THE ASSISTANT SECRETARY
POLICY, MANAGEMENT AND BUDGET
Washington, DC 20240



JUN 13 2005

David Gootnick
Director,
International Affairs and Trade
Government Accountability Office

Dear Mr. Gootnick:

Thank you for the opportunity to respond to the U.S. Office of Government Accountability (GAO) draft report aptly entitled, "Compacts of Free Association: Implementation of New Funding and Accountability Requirements Underway, but Planning Challenges Remain" (Report).

We find the Report to be mostly accurate and well-balanced. The reviewers clearly understand that significant changes have been made in the Compact of Free Association (Compact) relationships and that the new accountability regimes are making an impact. The reviewers have also accurately found that as the governments of the United States, the Federated States of Micronesia and the Republic of the Marshall Islands have implemented the new agreements, certain obstacles and problems have been encountered. As reported, these include oversight issues, gaps in the Compact nations' strategic planning, and compliance matters.

We concur with the recommendations to the Secretary of the Interior for actions by the Deputy Assistant Secretary (DAS) for Insular Affairs, both in his DAS capacity and as Chairman of the bi-lateral joint economic management committees. We have arrived at many of these conclusions ourselves and will implement them through our internal budget and planning process and, to the extent possible, through the joint economic management committees.

The Department of the Interior has been deeply engaged in the day-to-day actions necessary to implement the new agreements and will continue to work with OIA to identify the necessary resources needed to provide sufficient on-site, oversight review of OIA grants in the FSM and RMI. The Department does not believe that the statement on Page 37 of the Report, stating that the Department has not supported increased funding for on-site reviews, is accurate. The Department has supported the creation and establishment of the OIA Hawaii field office and will continue to support the work that it does overseeing the Compact of Free Association grants.

See comment.

Appendix IV
Comments from the Department of the
Interior

We appreciate GAO's review to better understand the status of the Compacts of Free Association and we commend the professionalism and experience of the GAO staff assigned to the review. It is to our benefit that this report emerged early in the new Compact regime.

If you have any questions concerning the response, please contact David B. Cohen, Deputy Assistant Secretary for Insular Affairs, or Nikolao Pula, Director of the Office of Insular Affairs, at (202) 208-4736.

Sincerely,



P. Lynn Scarlett

The following is GAO's comment on the letter from the Department of the Interior dated June 13, 2005.

GAO Comment

We recognize that the Department of the Interior has supported the creation of the OIA Honolulu field office to assist in compact implementation. However, officials from OIA have stated that budgetary constraints have prevented staff from conducting sufficient on-sight review in the FSM and the RMI and that the department has not supported increased funds for this purpose.

Comments from the Department of State

Note: GAO comment supplementing those in the report text appears at the end of this appendix.



United States Department of State

Assistant Secretary and Chief Financial Officer

Washington, D.C. 20520

Ms. Jacquelyn Williams-Bridgers
Managing Director
International Affairs and Trade
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548-0001

JUL - 4 2005

Dear Ms. Williams-Bridgers:

We appreciate the opportunity to review your draft report, "COMPACTS OF FREE ASSOCIATION: Implementation of New Funding and Accountability Requirements Well Underway, but Planning Challenges Remain," GAO Job Code 320303.

The enclosed Department of State comments are provided for incorporation with this letter as an appendix to the final report.

If you have any questions concerning this response, please contact Micah Watson, Pacific Islands Desk Officer, Bureau of East Asian and Pacific Affairs, at (202) 736-4712.

Sincerely,

Sid Kaplan (Acting)

cc: GAO – Leslie Holen
EAP – Christopher Hill
State/OIG – Mark Duda

Department of State Comments on GAO Draft Report
**COMPACTS OF FREE ASSOCIATION: Implementation of New Funding
and Accountability Requirements Well Underway,
but Planning Challenges Remain**
(GAO-05-633, GAO Code 320303)

We appreciate the opportunity to comment on your draft report, “COMPACTS OF FREE ASSOCIATION: Implementation of New Funding and Accountability Requirements Well Underway, but Planning Challenges Remain.” The report is a frank and fair assessment of the Administration’s first year of implementation of the amended Compacts and highlights successes and challenges that will inform the Department of State’s continuing work.

We are writing to ensure that there is no misunderstanding regarding the relationship between the annual U.S. grant assistance through Fiscal Year 2023 to the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) under the amended Compacts of Free Association and the revenue generated by the Trust Funds starting in Fiscal Year 2024.

The amounts of U.S. annual grant assistance through Fiscal Year 2023 are listed in sections 216 and 217 of the FSM and RMI amended Compacts respectively (subject to the inflation adjustment of sections 217 and 218, respectively). The amended Compacts do not provide for U.S. grant assistance beyond Fiscal Year 2023.

As stated in the preamble and Article 3 of the Trust Fund Agreements with the two countries, the establishment of the FSM and RMI Trust Funds reflects the desire “to contribute to the long-term budgetary self-reliance” of the FSM and RMI to provide their governments “with an ongoing source of revenue after Fiscal Year 2023.” The amended Compacts and their subsidiary agreements contain no commitments, express or implied, regarding the level of the revenue that will be generated by the Trust Funds, nor is there any commitment regarding the degree to which the revenue will “contribute” to the long-term budgetary self-reliance of the FSM and RMI. The amended Compacts and subsidiary agreements do not speak of the revenue from the Trust Funds as “replacing” the annual U.S. grant assistance but merely as providing one source of revenue after Fiscal Year 2023. To the extent the term “replace” is used by anyone to describe a connection

See comment.

between the Trust Fund revenue and the previous annual assistance grants, it can be misleading as it could wrongly be interpreted as meaning the Trust Fund revenue is required to, intended to, expected to, or designed to equal previous annual grant assistance.

In his July 10, 2003 testimony to the U.S. House Committee on Resources and July 15, 2003 testimony to the U.S. Senate Committee on Energy and Natural Resources, Compact Negotiator Albert V. Short similarly and accurately refers to the Trust Funds as providing "an ongoing source of revenue." The Administration has consistently made this point for the past three years.

I would like again to thank the GAO for the collaborative approach they took to the researching and writing of this report, and for allowing the Department of State to comment on it prior to publication.

The following is GAO's comment on the letter from the Department of State dated July 1, 2005.

GAO Comment

We agree that the amended compacts and their subsidiary agreements contain no commitments regarding the level of revenue that will be generated by the trust funds, and they do not speak of the revenue from the trust funds as "replacing" annual U.S. grant assistance after fiscal year 2023. However, for the sake of assessing the possible difficulty of transitioning from grant assistance to trust fund earnings, we have performed calculations based on U.S., FSM, and RMI trust fund contributions and various rates of return, to forecast the possibility that trust fund earnings will fully replace grant assistance beginning in 2024 (see p. 25).

Comments from the Department of Health and Human Services

Note: GAO comment supplementing those in the report text appears at the end of this appendix.



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

JUN 7 2005

Mr. David Gootnick
Director
International Affairs and Trade
U.S. Government Accountability Office
Washington, DC 20548

Dear Mr. Gootnick:

Enclosed are the Department's comments on the U.S. Government Accountability Office's (GAO's) draft report entitled, "COMPACTS OF FREE ASSOCIATION—Implementation of New Funding and Accountability Requirements Well Under Way, but Planning Challenges Remain" (GAO-05-633). The comments represent the tentative position of the Department and are subject to reevaluation when the final version of this report is received.

The Department provided several technical comments directly to your staff.

The Department appreciates the opportunity to comment on this draft report before its publication.

Sincerely,

Daniel R. Levinson
Acting Inspector General

Enclosure

The Office of Inspector General (OIG) is transmitting the Department's response to this draft report in our capacity as the Department's designated focal point and coordinator for U.S. Government Accountability Office reports. OIG has not conducted an independent assessment of these comments and therefore expresses no opinion on them.

COMMENTS OF THE U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES ON THE U.S. GOVERNMENT ACCOUNTABILITY OFFICE'S REPORT ENTITLED, "COMPACTS OF FREE ASSOCIATION—IMPLEMENTATION OF NEW FUNDING AND ACCOUNTABILITY REQUIREMENTS WELL UNDER WAY, BUT PLANNING CHALLENGES REMAIN" (GAO-05-633)

The Department of Health and Human Services (HHS) appreciates the opportunity to review the Government Accountability Office's (GAO's) draft report.

As a member of the Joint Economic Management and Financial Accountability Committee (JEMFAC) and the Joint Economic Management Committee (JEMCO) overseeing the Compacts with the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM), HHS is committed to working with the U.S. Departments of Interior (DOI) and State, other U.S. Government agencies, and the two countries in promoting and improving the health and well-being of the citizens of the FSM and RMI by maximizing the impact and effectiveness of Compact resources. HHS finds this report to be a comprehensive and timely overview of the accomplishments and challenges associated with the early phases of implementation of the amended Compacts.

We concur with the overall conclusion of the report that over a short time period both sides have made great strides in implementing the complex financial and technical oversight requirements of the Compacts, while some shortcomings exist. As mentioned on page 40 of the report, by establishing a Honolulu field office and investing in staff to provide monitoring and oversight, the Office of Insular Affairs (OIA) within DOI has demonstrated its commitment to successful implementation of the amended Compacts. We believe HHS has also demonstrated its commitment to accomplish this goal through the significant time investment of personnel in our Office of Global Health Affairs, through the coordination efforts of several HHS agencies, and (as mentioned in the report) through a senior HHS assignee to DOI/OIA's Honolulu office. This assignment facilitates coordination and collaboration on health issues pertinent to the Compacts, and will assure smooth integration of other HHS funds that go to RMI and FSM with pertinent Compact activities.

We request several minor corrections to the draft document. The report indicates on page 10 that grant assistance is in six sectors, one of which is "health care." We believe the term "health," used elsewhere throughout the document, is more appropriate, as care is only one aspect of promoting health. Footnote 36 indicates the HHS representative is expected to spend 40 percent of his time in FSM and RMI. However, as this new position is meant to support activities in all six U.S.-affiliated Pacific jurisdictions and to interact with relevant international agencies such as the World Health Organization and Secretariate of the Pacific Community (SPC), this figure is more reflective of likely cumulative travel to accomplish all of these goals. There is no specific target for travel in the FSM and RMI.

See comment.

Appendix VI
Comments from the Department of Health
and Human Services

After the initial phase of compact implementation, HHS believes it will be important to monitor not only adherence to financial and management requirements, but to assure the expected health, education, and infrastructure benefits are achieved. Since the compacts are performance based, it is necessary that the impact of the sector grants can be measured and documented.

The following is GAO's comment on the letter from the Department of Health and Human Services dated June 7, 2005.

GAO Comment

We have made the requested corrections. Specifically, we now use the term "health grant" to characterize this particular compact sector grant throughout the report, and we have deleted the footnote describing travel to the FSM and the RMI by the HHS representative stationed in Honolulu.

Comments from the Government of the Federated States of Micronesia

Note: GAO comment supplementing those in the report text appears at the end of this appendix.



*Office of
the Ambassador*

EMBASSY OF THE
FEDERATED STATES OF MICRONESIA
1725 N STREET, N.W.
WASHINGTON, D.C. 20036

TELEPHONE: (202) 223-4383
FACSIMILE: (202) 223-4391
EMAIL: FSMAMB@aol.com

27 June 2005

Dr Emil Friberg Jr
US General Accounting Office
441 G Street, NW, Room 4964
Washington, DC 20548

Dear Dr Friberg:

I have the pleasure of transmitting the comments of the Government of the Federated States of Micronesia on the Draft Report by the General Accounting Office entitled, "Compacts of Free Association: Implementation of New Funding and Accountability Requirements Well Underway, but Planning Challenges Remain."

In the interest of economy of space, the comments are in a summary form. We would be pleased as well to provide the detailed comments or explanations upon which the attached summary comments are based, should you require.

Please do not hesitate letting us know if you have any question.

Sincerely,

A handwritten signature in black ink, appearing to read "Jesse B Marehalau".

Jesse B Marehalau
Ambassador

Appendix VII
Comments from the Government of the
Federated States of Micronesia



*Office of
the Ambassador*

EMBASSY OF THE
FEDERATED STATES OF MICRONESIA
WASHINGTON, D.C.

June 27, 2005

**COMMENTS BY THE GOVERNMENT OF THE FEDERATED
STATES OF MICRONESIA
ON THE DRAFT GAO REPORT,**

**“Compacts of Free Association: Implementation of New Funding and
Accountability Requirements Well Underway, but Planning Challenges
Remain” - GAO-05-633**

Overview: The Government of the Federated States of Micronesia (FSM) welcomes this initiative by the United States Congress to assess the effectiveness thus far of the implementation of funding and accountability requirements under the amended Compacts. We feel that the timely review provided by the GAO’s Draft Report will be of positive value, not only to the U.S. Congress and Administration, but to the Micronesian Governments as well.

Before moving on to more specific comments and responses, we would like to express appreciation to our friends and colleagues within the GAO who traveled far and worked long and hard to produce this draft. We are grateful for the overall measured tone of the draft which, without glossing over shortcomings, seems to give due credit to the efforts being made by the FSM to rise to the many new challenges presented by the Amended Compact. One notable feature of the draft that will contribute much to the usefulness of the final Report is the separate treatment given, where appropriate, to the performances of the two Governments, the FSM and the RMI. This allows a far better understanding of the implementation challenges, given the different circumstances of the two nations.

We are gratified to state that the reviewer of these comments will find we are able to report progress made on almost every GAO finding, since the draft was compiled. Our implementation, particularly of the new funding and accountability requirements, doubtless will need constant monitoring, evaluation and improvement throughout the new funding period. Many might reasonably question, even now, whether we should or could have done better in the beginning in one area or another, but on the whole, we are confident that the United States Congress will conclude from the GAO Report and subsequent oversight hearings, that the FSM is making a genuine effort at compliance under difficult conditions, and that that effort is showing results.

The First Year: During the first full year of Amended Compact funding, FY 2004, the FSM struggled to develop, finalize and approve a number of plans that are closely tied to decision-making and budgeting as regards Compact grant funds. It was also necessary to move quickly to establish a far more elaborate Compact management infrastructure at both State and National government levels, than had been needed before. All the while, the Compact funds were being made available and the JEMCO process was underway. By necessity, it became necessary to proceed on what we would describe as an informed, ad hoc basis. As noted by GAO, this resulted in an inability in the first year for the FSM fully to meet the new requirements and fully utilize all the funds that were available. The funds do carry over, however, and will be utilized. Whatever else might be said, this difficult year proceeded in compliance with the basic mandates of the Fiscal Procedures Agreement.

Meeting the Challenges: The challenge experienced by the FSM in completing the necessary plans in order to come to grips with "strategic planning issues" as cited in the GAO draft is not denied, but it can be reported that the FSM has now put into place most, if not all that is required. The internal process for the FSM, which by necessity had to be highly participatory at all levels of our dispersed governments, required time. The Infrastructure Development Plan, together with engagement of a firm to assist with contracting, is now accomplished. More broadly, in early June the FSM submitted to the US for JEMCO concurrence its overall, multi-year Strategic Development Plan. This will now provide a concrete basis upon which the JEMCO can assure that, to use GAO terminology, "the allocations of sector grants are linked to amended Compact development goals." It will also provide an appropriate backdrop for discussion, to any extent it might be appropriate within this forum, of the internal allocation of sector grant funds within the FSM.

Like much of the rest of the Amended Compact experience, the full establishment and implementation of the FSM Trust Fund has taken time. Most importantly, the Fund has been legally established and the required initial financial contributions have been made and secured. At this writing, the FSM Financial consultants are in the final stages of evaluating proposals that were submitted for the positions of Trustee and Investment Advisor. This process should be completed within the next 30 days, shortly after which the Trust Fund's investment program will be launched.

One of the most difficult implementation problems for the FSM has been the unexpected insistence by the US members of JEMCO that the FSM, contrary to expectations established during the Amended Compact negotiations, cannot rely upon funding in the relatively small Public Sector Capacity Building grant to support a range of vital public sector operations, such as in law enforcement, judiciary, audit and others. The difficulty stems from the inescapable fact that local revenues, the only alternative source, are quite inadequate to support these vital government services. Realization of the means to increase local revenues will depend, over time, on the success of various Compact development-oriented mechanisms. Nevertheless, the US Members of JEMCO have imposed an arbitrary five-year "withdrawal" from the use of funds in the Public Sector Capacity Building grant to support these essential government operations. The

Appendix VII
Comments from the Government of the
Federated States of Micronesia

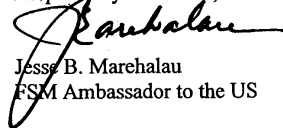
See comment.

theory seems to be that an already-shrinking economy in the midst of Compact cutbacks can somehow produce more local revenues by increasing taxes. The GAO draft cites an FSM "failure" to come up with a "strategy" to meet this US-imposed JEMCO requirement. Actually, the FSM did, however reluctantly, submit a five-year plan for meeting this onerous and, in our view, counterproductive requirement, which was accepted by the Department of the Interior. The FSM States are bending their best efforts to comply with this "plan," and still provide essential public services. To say that this is hardly the atmosphere in which to move toward the broader development objectives of the Amended Compact is to state the obvious.

Several of the Departments within the FSM Executive Branch have prepared technical comments aimed at particular sections of the GAO draft, which will be supplied separately. It is hoped that these also will be taken into consideration.

The FSM wishes to express gratitude for the fairness and even-handedness of the draft report. As experience unfolds under the Amended Compact, we look forward to the continuing oversight of our efforts by the United States Congress.

Respectfully submitted,



Jesse B. Marehalau
FSM Ambassador to the US

The following is GAO's comment on the letter from the government of the Federated States of Micronesia dated June 27, 2005.

GAO Comment

The report notes that the FSM government submitted a document to OIA that calculates percentage decreases for basic government operations expenditures from the FSM's public sector capacity building grant through 2009. We also note that there is no additional plan describing what policy steps will be taken or the agencies and activities that will be affected by the decreases. Therefore, we do not believe that this schedule can be construed as a "strategy" that identifies where spending decreases will occur and how they will be managed.

Comments from the Government of the Republic of the Marshall Islands

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



Republic of the Marshall Islands

OFFICE OF THE CHIEF SECRETARY
P.O. BOX 15
Majuro, Marshall Islands MH 96960

June 28, 2005

Mr. David Gootnick
Director
International Affairs and Trade
U.S. General Accounting Office
441 G St. N.W
Washington D.C. 20548

**Republic of the Marshall Islands Comments on the GAO Report (GAO-05-633):
“Compact of Free Association: Implementation of New Funding and Accountability
Requirements Well Underway, but Challenges Remain (Draft)”**

Dear Mr. Gootnick:

Thank you for providing draft copy of the above-captioned U.S. General Accounting Office (GAO) report and for allowing us some time to review and make comments.

The Government of the Republic of the Marshall Islands (RMI) has endeavored to not only meet the requirements of the Compact of Free Association, as amended, which went into effect in the Republic of the Marshall Islands and the United States on May 1, 2004, but also has maintained an unchanging course, even before the amended Compact was implemented, to improve our economic and fiscal management in order for us to realize sustainable and real economic growth along with improving living standards for all our people. This major task, of which the amended Compact is only one component, has been addressed by my Government in a progressive manner and has taken substantial investments to reform our governmental operations, policies and priorities. Suffice it to say, this approach is a new way of doing things and such far-reaching change takes time to not only be implemented but also to change attitudes, standards and performance, and to achieve tangible results.

The GAO report is informative and helpful to us: informative in a way to receive a more objective view regarding how far we have progressed and to also identify weaknesses or gaps in the areas of public policy and management; and helpful for us to concentrate on those gaps so that we improve not only achieving the intent of the amended Compact but also to achieve the economic advances and social stability that we are responsible to help achieve for our country.

Tel: 625-3234 Fax: 625-3649

Appendix VIII
Comments from the Government of the
Republic of the Marshall Islands

Mr. David Gootnick
June 28, 2005
Page 2

Overall, the RMI believes that the report provides much detailed information. However, we think that some representations or analysis regarding the RMI portrayed in the document needs to be corrected to be totally accurate. Second, the focus on long term strategic planning for use of funds and other planning efforts identified in the report are overemphasized and some of the analysis and recommendations are not the purpose or intent of the amended Compact's Title Two or Fiscal Procedures Agreement. Third, there is not sufficient emphasis on major components of the economic package because of lack of full implementation on the part of the United States. This last issue involves the Trust Fund component which is not yet fully invested; the Supplemental Education Grant for which an adequate U.S. system of delivery and oversight is not yet clear and funds not yet fully available; and the lack of an agreement for the allocation and use of judicial training grants with the RMI as specified in the Fiscal Procedures Agreement. We are entering Year 3 of the amended Compact and these issues are not yet resolved.

Please find an attached paper that provides clarifications or corrections of the report as well as more fully illustrates the RMI's activities and views.

With regards to the third point—unfulfilled implementation of 1) the Trust Fund, 2) the Supplemental Education Grant (SEG) , and 3) judicial training grants, we urge that these components are fully implemented in the manner intended in the amended Compact at the earliest time possible. For the Trust Fund, we have already lost almost three years of earnings. As pointed out in the previous GAO report *Compact of Free Association: An Assessment of the Amended Compact and Related Agreements*, the Trust Fund, even if it was invested from 2004 to 2023, would be unable to fully meet its purpose as envisaged in the amended Compact. Thus, no matter what planning we do today, if the Trust Fund earnings are insufficient in 2024, any plans to achieve economic and fiscal stability will not be achieved by that time. The RMI remains extremely concerned regarding the adequacy of the Trust Fund after Title Two grant assistance ends in 2023. In addition, we remain concerned that the cumulative annual decrement from the Compact base grant (that is added to the Trust Fund) along with only a partial inflation adjustment to the grant funding will be a difficult challenge in bringing positive change for reform and development. Currently, we have been dealing with the decrement reduction and real loss of grant assistance value by reducing costs and achieving efficiencies. However, this will be more difficult to do in the future as the cumulative decrement grows and the real value of the grants decline. We would hope that GAO looks into this issue during its upcoming economic review.

For the SEG, it has been a difficult transition period from the existing Federal Programs to the grant implementation. The whole process would improve with better coordination within the Administration so that we do not receive differing U.S. views and interpretations of funding delivery and use. We also believe that there are issues being encountered within the Administration in terms of making these funds available to the RMI to replace federal programs as intended by Congress. Finally, since these funds depend on annual appropriations, as opposed to a permanent Congressional appropriation for other amended Compact funding, future planning regarding these funds has a distinct uncertainty to them. My government, and our children and educators, would greatly benefit from a more straight-

See comment 1.
See comment 2.
See comment 3.
See comment 4.

See comment 5.

Appendix VIII
Comments from the Government of the
Republic of the Marshall Islands

Mr. David Gootnick
June 28, 2005
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forward manner regarding the delivery, management and availability of these funds. Our own efforts for SEG management must also improve. We have been and will continue to strengthen the planning, management, and use of these funds so that the amended Compact's education objectives are fulfilled.

Finally, the Judicial Training Grants were provided to the Pacific Islands Committee of the Ninth Circuit Judicial Council without the agreement of the RMI as more fully described in the attached comments.

We hope that the above and attached comments are useful and constructive to inform readers of the true progress that has been made and some of the shortcomings that have to be addressed. We also hope the comments portray the interest of the RMI in assuring the U.S. Congress and Administration that we take the requirements of the amended Compact seriously and we are striving to not only meet these requirements but to apply the amended Compact's economic provisions so that our country benefits in the short, medium and long term.

Again, thank you and your staff for the time and effort in preparing the report, and please let us know if you require additional information.

Sincerely,



Robert S. Muller
Chief Secretary

Copy to: Hon. Gerald M. Zackios, Minister of Foreign Affairs, RMI
Hon. Brenson S. Wase, Minister of Finance, RMI
Ambassador Banny deBrum, RMI Embassy, Washington, DC

Attachment: RMI Comments on GAO Report (GAO-05-633) [9 pgs]

The following are GAO's comments on the letter from the government of the Republic of the Marshall Islands dated June 28, 2005.

GAO Comments

1. We made several factual corrections to the report, based on the RMI's technical comments (see comment 5).
2. The RMI's technical comments emphasize the government's detailed strategic planning efforts. We do not dispute that the RMI government has undertaken planning initiatives regarding the use of compact funds in each sector. Our point remains that (1) it is unclear whether JEMFAC has approved RMI planning documentation addressing the use of grant funds and (2) there have been no bilateral discussions addressing how the RMI will achieve the amended compact's stated goals of economic advancement and budgetary self-reliance.
3. Our recommendations, which are intended to further ensure planning for the effective use of compact funding, are directed to the Department of the Interior. In its formal comment letter, Interior concurred with the recommendations and stated its intention to implement them through the department's internal budget and planning process and, to the extent possible, through the joint economic management committees.
4. We intend to review the trust funds, the supplemental education grant, and the judicial training funding in more detail during subsequent work.
5. Per an agreement with the RMI government, we are not reproducing the RMI's technical paper. However, we have used comments in the paper to make factual corrections to the report.

GAO Contact and Staff Acknowledgments

GAO Contact

David Gootnick, 202-512-4128

Acknowledgments

In addition to the contact named above, Emil Friberg, Leslie Holen, Eddie Uyekawa, Reid Lowe, Kendall Schaefer, and Mary Moutsos made key contributions to this report.

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