United States Government Accountability Office

Report to the Chairman, Committee on Energy and Natural Resources, U.S. Senate

May 2018

COMPACTS OF FREE ASSOCIATION

Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income

GAO-18-415

GAO Highlights

Highlights of GAO-18-415, a report to the Chairman, Committee on Energy and Natural Resources, U.S. Senate

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Why GAO Did This Study

In 2003, the United States approved amended compacts of free association with the FSM and RMI, providing a total of $3.6 billion in economic assistance in fiscal years 2004 through 2023 and access to several U.S. programs and services. Compact grant funding, overseen by the Department of the Interior, generally decreases annually. However, the amount of the annual decrease in grants is added to the annual U.S. contributions to the compact trust funds, managed by joint U.S.-FSM and U.S.-RMI trust fund committees. Trust fund earnings are intended to provide a source of income after compact grants end in 2023, but GAO and others have previously found that the trust funds may not provide sustainable income.

GAO was asked to examine preparations for the transition in 2023. This report examines (1) the use and role of U.S. funds and programs in FSM and RMI budgets, (2) projected trust fund disbursements and potential strategies to address risks to those disbursements, and (3) FSM and RMI plans to prepare for grant decreases and the transition to trust fund income. GAO reviewed compact agreements, audit reports, and U.S. law; modeled trust fund performance under existing conditions and using potential strategies; and reviewed FSM and RMI plans. GAO visited each country and interviewed FSM, RMI, and U.S. officials.

What GAO Recommends

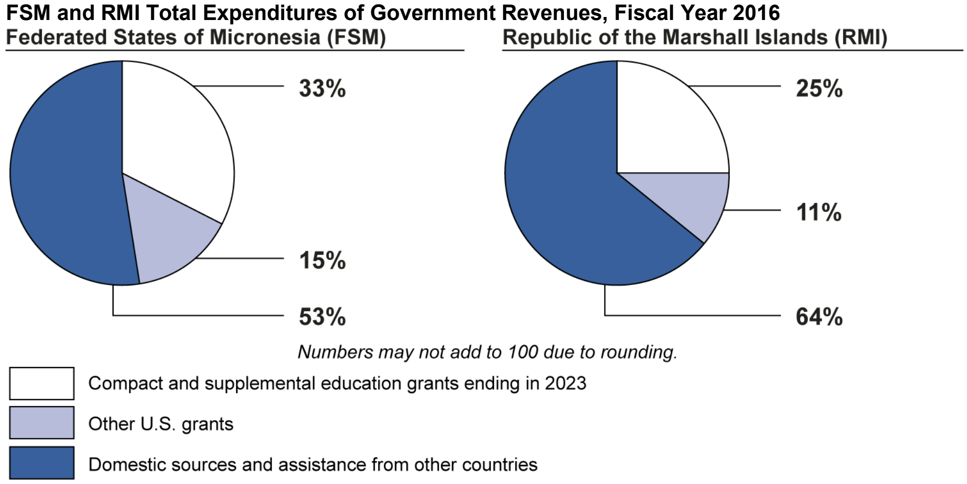
GAO recommends that Interior work with the compact trust fund committees to develop distribution policies and fiscal procedures for the funds and to address disbursement timing. Interior concurred with the recommendations.

View GAO-18-415. For more information, contact David Gootnick at (202) 512-3149 or gootnickd@gao.gov.

What GAO Found

The Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) continue to rely on U.S. grants and programs, including several that are scheduled to end in 2023. U.S. compact sector and supplemental education grants, both scheduled to end in 2023, support a third of the FSM's and a quarter of the RMI's expenditures. Agreements providing U.S. aviation, disaster relief, postal, weather, and other programs and services are scheduled to end in 2024, but some agencies may provide programs and services similar to those in the agreements under other authorities. FSM and RMI eligibility for some other U.S. grants and programs is expected to continue after 2023.

FSM and RMI Total Expenditures of Government Revenues, Fiscal Year 2016



Sources: GAO analysis of P.L. 108-188, the RMI Military Use and Operating Rights Agreement (MUORA); and FSM and RMI single audit reports. | GAO-18-415

Disbursements from the compact trust funds face risks that the trust fund committees have not addressed. GAO found that the trust funds are increasingly likely to provide no annual disbursements in some years and to not sustain their value. Potential strategies such as reduced trust fund disbursements or additional contributions from the countries or other sources could help address these risks. Changing the trust fund disbursement policies could also address these risks but may require revising the trust fund agreements with each country. However, the trust fund committees have not prepared distribution policies, required by the agreements, which could assist the countries in planning for the 2023 transition to trust fund income. The committees also have not prepared the required fiscal procedures for oversight of the disbursements or addressed differences between the timing of their annual determination of the disbursement amounts and the FSM's and RMI's annual budget cycles.

The FSM and RMI did not implement planned budget reductions to address decreasing compact grants owing to increased revenues from other sources that offset the grant decreases. Current FSM and RMI infrastructure plans address the 2023 transition, while health and education plans focus on strategic goals. Both countries have established new compact planning committees to identify future challenges and develop plans for the 2023 transition to trust fund income.

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Abbreviations

DOT	U.S. Department of Transportation
Education	U.S. Department of Education
FAA	Federal Aviation Administration
FEMA	Federal Emergency Management Agency
FSM	Federated States of Micronesia
GDP	gross domestic product
Interior	U.S. Department of the Interior
JEMFAC	Joint Economic Management and Financial Accountability Committee
JEMCO	Joint Economic Management Committee
MAR	moving adjustment rule
MUORA	Military Use and Operating Rights Agreement
RMI	Republic of the Marshall Islands
SAFER	sustainability adjustment for enhanced reliability
SEG	supplemental education grant
State	U.S. Department of State
USAID	U.S. Agency for International Development

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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May 17, 2018

The Honorable Lisa Murkowski
Chairman
Committee on Energy and Natural Resources
United States Senate

Dear Madam Chairman:

In 2003, the United States approved amended compacts of free association with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) that provide for a total of $3.6 billion in compact sector grants, trust fund contributions, and other grants, as well as access to several U.S. programs and services, in fiscal years 2004 through 2023.[1] This compact assistance is intended to assist the FSM and RMI governments in their efforts to promote the self-sufficiency and budgetary self-reliance of their people. Compact sector grants, managed by the U.S. Department of the Interior (Interior), generally decrease annually before their scheduled end in 2023. However, the amount of the annual decrease in compact sector grants (also referred to as the annual decrement) is added to the annual U.S. contributions to the compact trust fund established for the benefit of each country. Investment earnings from the compact trust funds are intended to provide an annual source of revenue after the compact sector grants are scheduled to end in 2023. In 2007, we reported that the compact trust funds may not provide sustainable income after the compact sector grants end.[2] As 2023 approaches, questions remain as to whether the FSM and RMI will successfully transition to greater self-reliance when the 20 years of U.S. compact economic assistance end.

[1]Compact of Free Association Amendments Act of 2003 (Pub. L. No. 108-188). The $3.6 billion in compact assistance includes compact sector grants, trust fund contributions, audit grants, Kwajalein impact payments and judicial training grants as well as grants provided to the RMI related to the nuclear-affected atolls of Rongelap and Enewetak. The total includes inflation adjustments for prior-year assistance and estimated inflation adjustments for future-year assistance but does not include the cost to the United States to provide programs and services through the compacts' programs and services agreements in fiscal years 2004 through 2023.

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

You asked us to review issues related to the FSM's and RMI's transition from compact grant assistance to relying on income from the compact trust funds. This report examines (1) the use and role of U.S. funds and programs in the FSM and RMI budgets, (2) projected compact trust fund disbursements and potential strategies to address risks to those disbursements, and (3) FSM and RMI efforts to prepare for the scheduled decrements in compact grant funding and the transition to relying on compact trust fund income.

To examine the use and role of U.S. funds and programs in the FSM and RMI, we interviewed U.S. officials, and we also interviewed FSM and RMI officials during our site visits to each country in July and August 2017. In addition, we reviewed U.S. law; the FSM and RMI compact agreements and the associated military use and operating rights agreements (MUORA) and programs and services agreements; the FSM and RMI government and component unit single audit reports for fiscal years 2012 through 2016; and U.S. Region IX reports for fiscal years 2015 and 2016.[3] To assess the reliability of federal program funding information, we reviewed the single audit reports and found that the auditors did not express any qualified or adverse opinions regarding the information the auditors used to prepare the audits' Schedule of Expenditures of Federal Awards listing the amount and use of federal grants. We therefore concluded that these data were sufficiently reliable for estimating the role of federal programs in the FSM and RMI budgets. To determine the legal status of U.S. grants, programs, and services after 2023, we analyzed U.S. law and requested review of our analysis from officials of U.S. agencies that provide grants, programs, or services in the FSM and RMI.[4] Although we took multiple steps to validate our list of programs with the FSM and RMI and the relevant U.S. agencies, our analysis may not have captured all U.S. grants and programs provided in the FSM and RMI.

[3]Region IX Federal Regional Council, Outer Pacific Committee, *FY 2016 Report on Federal Financial Assistance to the U.S. Pacific and Caribbean Islands* (May 1, 2017), and *FY 2015 Report on U.S. Federal Financial Assistance to the U.S. Affiliated Pacific Islands* (March 2016).

[4]We consulted officials from the Departments of Agriculture, Commerce, Defense, Education, Energy, Health and Human Services, the Interior, Labor, State, and Transportation; the Federal Communications Commission; the Federal Deposit Insurance Corporation; the Federal Emergency Management Agency; the National Science Foundation; the U.S. Agency for International Development; and the U.S. Postal Service.

To examine projected compact trust fund disbursements and actions to address risks, we reviewed previous studies of the compact trust funds, the U.S.-FSM and U.S.-RMI compact trust fund agreements and other governance and reporting documents, such as investment policy statements, presentations before the committees for each compact trust fund, audits, and annual reports. We also interviewed compact trust fund committee members and the funds' administrator, investment advisers, and money managers.

- To project the compact trust funds' average disbursements, likelihood of years with zero disbursement, and likelihood of maintaining value after fiscal year 2023, we built a Monte Carlo simulation model and performed 10,000 trial runs of projected returns and disbursements.[5] We used the unaudited fiscal year 2017 year-end balances of the compact trust funds as the starting point for our projections. To assess the reliability of the unaudited balances, we reviewed the previous years' audits and discussed with the trust funds' administrator whether these audits had resulted in any significant change between the preliminary unaudited balances and the final audited balances. The March 2018 audited fund balances, released after we completed our analysis, were within $5 of the unaudited fund balances. We concluded that the unaudited balances were sufficiently reliable as a basis for our projections of future trust fund performance. To assess our net rate of return assumptions, we reviewed the trust fund money managers' capital market assumptions and projections and tested varying rates of return and return distributions.
- To consider the effects of alternative trust fund strategies, we again performed the Monte Carlo analysis to determine the likely effects, relative to the baseline, of five potential strategies that used one of three approaches: (1) reducing annual compact trust fund disbursements, (2) making additional contributions, and (3) changing the disbursement policies, including strategies that would require changes to the trust fund agreements. To select these potential strategies, we reviewed previous studies of the compact trust funds and interviewed agency and trust fund officials.

To examine FSM and RMI preparations to address the compact grant decrements and the transition to trust fund support, we interviewed FSM

[5]A Monte Carlo analysis is a problem-solving technique that approximates the probability of certain outcomes by performing multiple trial runs, called simulations, using random variables. The simulations capture the volatility of market returns and reflect that volatility in the projection of future earnings.

and RMI officials and reviewed the FSM and RMI decrement management plans. We compared these plans to single audit reports, budgets, and actions to determine whether the plans were implemented. We also followed up with Interior and the FSM and RMI governments regarding the status of the plans and plan updates. To identify current planning documents for the key sectors of health, education, and infrastructure in the FSM and RMI as well as the status of current planning efforts, we obtained the plans from department heads in each key sector from the RMI and FSM national and state governments and confirmed our identification of the documents with FSM and RMI officials. We then reviewed these plans to determine whether the plans discussed budget changes to address the transition to relying on compact trust fund income after 2023. We also interviewed U.S., FSM, and RMI officials and reviewed documentation to identify and describe ongoing planning committees and working groups for the 2023 transition.

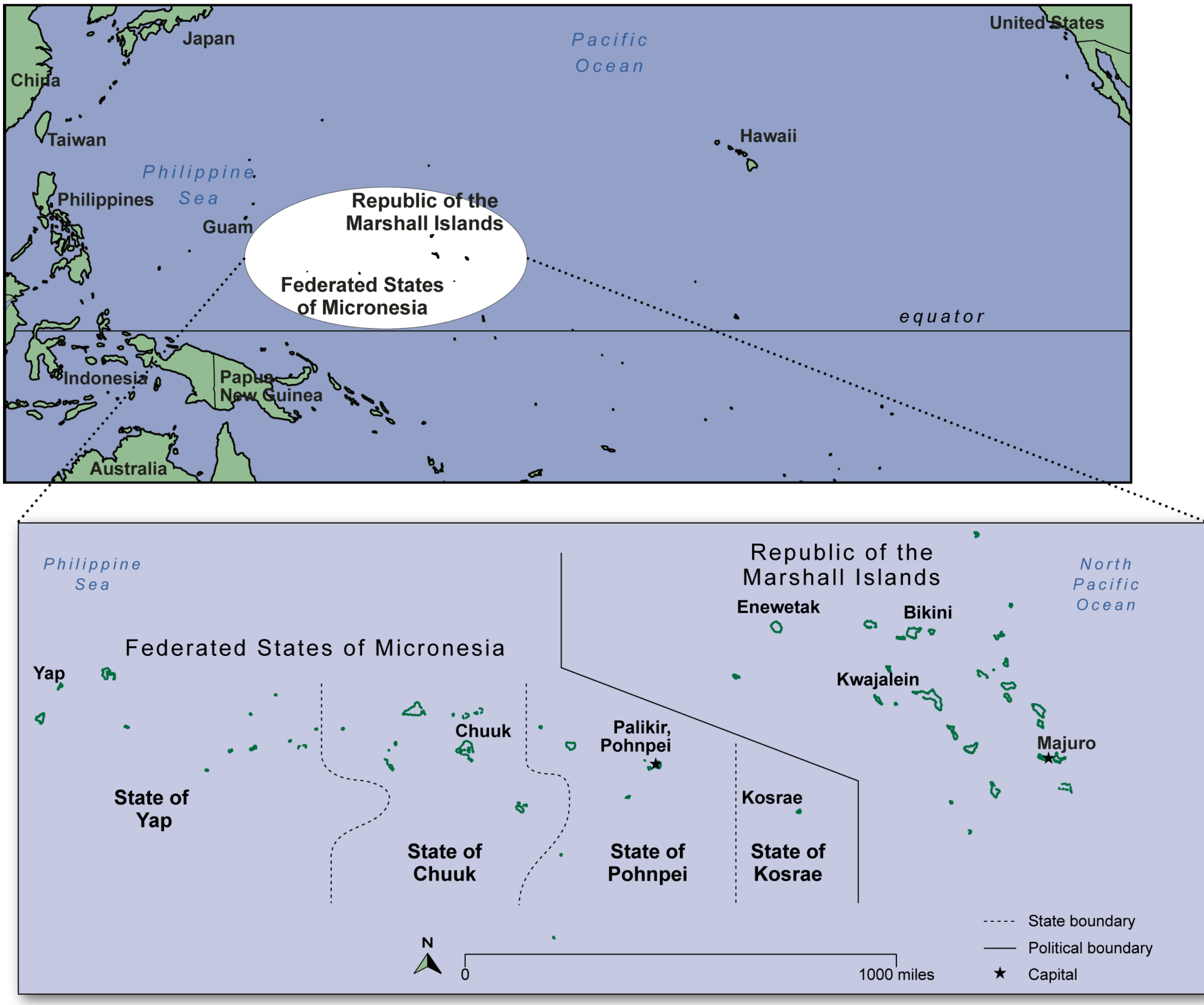
For more details of our objectives, scope, and methodology, see app. I.

We conducted this performance audit from March 2017 to May 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The FSM and the RMI are independent countries located about 3,000 miles southwest of Hawaii (see fig. 1).

Figure 1: Location and Map of the Federated States of Micronesia and Republic of the Marshall Islands



Sources: GAO presentation from Map Resources and National Oceanic and Atmospheric Administration (maps). | GAO-18-415

The FSM is a federation of four semiautonomous states—Chuuk, Kosrae, Pohnpei, and Yap—whose population and income vary widely. Chuuk, the largest state by population, has the lowest per capita gross domestic product (GDP). Overall, the FSM had a 2016 population of approximately 102,000 and a GDP per capita of about $3,200. The RMI's 2016 population was approximately 54,000 with a GDP per capita of about $3,600. The RMI's most recent census, in 2011, found that approximately three-quarters of the population lived in Majuro, the nation's capital, and on the island of Ebeye in the Kwajalein Atoll. Table 1 shows the FSM's, FSM states', and RMI's estimated population and annual GDP per capita in fiscal year 2016.

Table 1: FSM, FSM States, and RMI Estimated Population and Annual Gross Domestic Product (GDP) per Capita

Jurisdiction	2016 Population	Fiscal year 2016 GDP per capita (dollars)
Federated States of Micronesia (FSM)	102,453	3,220
FSM states		
Chuuk	46,688	1,994
Kosrae	6,227	3,376
Pohnpei	37,893	4,313
Yap	11,645	4,495
Republic of the Marshall Islands (RMI)	54,153	3,592

Source: Graduate School USA, FSM FY2016 Economic Brief, (August 2017) and RMI FY2016 Economic Brief, (August 2017). | GAO-18-415

FSM and RMI Government Revenues

FSM

The FSM states maintain considerable authority, relative to the FSM national government, to allocate U.S. assistance and implement budgetary policies. While the United States provides compact sector grants directly to the FSM national government, a large portion of these grants is passed through and provided to the four FSM states. The states also receive other U.S. program grants that have been passed through from the national government but may also receive grants directly from U.S. agencies.

Overall, FSM public sector revenue sources include U.S. compact and program grants; grants from other countries; taxation, including taxation of foreign corporations domiciled in the FSM; and Parties to the Nauru

Agreement fishing fees charged to vessels operating in its waters.[6] In addition to maintaining departmental budgets, both the FSM national government and the FSM states have government-owned enterprises and component units, such as public utilities and port authorities, whose operations are supported by public funds. Some of these component units also receive U.S. compact sector grants or other U.S. grants passed through the FSM national or state governments or directly from U.S. agencies. According to Graduate School USA, the FSM's public sector accounted for about 53 percent of all employment in the FSM in fiscal year 2016.[7]

RMI

The RMI government is responsible for allocating U.S. assistance in that country, though the RMI's 24 local governments exercise local government authority. RMI public sector revenue sources include U.S. compact and program grants, grants from other countries, ship and corporate registry earnings,[8] and Parties to the Nauru Agreement fishing fees. The RMI government also has state-owned enterprises and component units whose operations are supported by public funds. Some of these component units receive U.S. compact sector grants or other U.S. grants passed through the RMI government or directly from U.S. agencies. According to Graduate School USA, in fiscal year 2016, RMI's public sector accounted for approximately 48 percent of all employment in the RMI.[9] The U.S. Army Garrison–Kwajalein Atoll, located near Ebeye island, also provides a significant source of employment for Marshallese. In September 2017, U.S. Army Garrison-Kwajalein Atoll officials

[6]The members of the Parties to the Nauru Agreement are the FSM, Kiribati, Nauru, Palau, Papua New Guinea, the RMI, the Solomon Islands, and Tuvalu. These same countries also agreed on a limited number of fishing days for the year, based on scientific advice about the status of the tuna stocks; fishing days are then allocated by country and sold to the highest bidder.

[7]Graduate School USA, *Federated States of Micronesia Fiscal Year 2016 Statistical Appendices* (Honolulu, Hawaii: August 2017). Under contract to Interior, Graduate School USA has produced a series of annual economic reviews of the FSM and RMI. Graduate School USA is a private nonprofit educational institution, not affiliated with the federal government or any federal agency or department.

[8]The ship registry charges a fee for private vessels to register as RMI flagged vessels. The RMI contracts with a private company, International Registries Inc., to manage its ship and corporate registry and receives funds as a result of this arrangement.

[9]Graduate School USA, *Republic of the Marshall Islands Fiscal Year 2016 Statistical Appendices* (Honolulu, Hawaii: August 2017).

estimated that approximately 1,100 Marshallese were employed at the garrison.[10]

Compact of Free Association (1986–2003)

U.S. relations with the FSM and the RMI began during World War II, when the United States ended Japanese occupation of the region. Beginning in 1947, the United States administered the region under a United Nations trusteeship.[11] During the 1940s and 1950s, the RMI was the site of 67 U.S. nuclear weapons tests on or near Bikini and Enewetak Atolls. The four states of the FSM voted in a 1978 referendum to become an independent nation, while the RMI established a constitutional government and declared itself a republic in 1979. Under the trusteeship agreement, both newly formed nations remained subject to the authority of the United States until 1986.

In 1986, following a period of negotiations, the United States entered into a compact of free association with the FSM and the RMI that provided for economic assistance to the two countries, secured U.S. defense rights,[12]

[10]U.S. Army Garrison-Kwajalein Atoll is home to the Ronald Reagan Ballistic Missile Defense Test Site and its approximately 1,300 U.S. personnel, including military personnel, Army civilians, contractor employees, and family members on Kwajalein and Roi-Namur islands. According to the Department of Defense, the department also pays $17,021 annually as a retainer fee for the use of Bigen Island, which is located outside Kwajalein Atoll. While the Department of Defense has not used Bigen Island recently, the department continues to pay the retainer fee to secure the site for potential future testing activities.

[11]The region, designated the Trust Territory of the Pacific Islands, included the island groups that later became the FSM, the RMI, the Republic of Palau, and the Commonwealth of the Northern Mariana Islands. The Department of the Navy began civil administration of the trust territory on July 18, 1947; this responsibility was transferred to Interior in July 1951.

[12]The military use and operating rights agreements (MUORAs) with each country under the amended compacts provide the United States with special and substantial access to, and control of, defense sites in each country. There are no U.S. defense sites in the FSM. 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).

and allowed FSM and RMI citizens to migrate to the United States.[13] The compact provided a framework for the United States and the two countries to work toward achieving the following three main goals: (1) establish self-government for the FSM and the RMI, (2) ensure certain national security rights for all of the parties, and (3) assist the FSM and the RMI in their efforts to advance economic development and self-sufficiency. The compact's third goal was to be accomplished primarily through U.S. direct financial assistance to the FSM and the RMI.

Under the original compact, the FSM and the RMI used funds for general government operations; capital projects, such as building roads and investing in businesses; debt payments; and targeted sectors, such as energy and communications. The FSM concentrated much of its spending on government operations at both national and state levels, while the RMI emphasized capital spending. While the original compact set out specific obligations for reporting and consultations regarding the use of compact funds, the FSM, RMI, and U.S. governments provided little accountability over compact expenditures and did not ensure that funds were spent effectively or efficiently.[14]

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[13]Citizens of the Republic of Palau also received such migration rights through their separate Compact of Free Association in 1994. Section 141 of the FSM and RMI compacts, as amended, permits eligible citizens of the FSM and RMI to enter, reside, and work indefinitely in the United States, including its territories, without regard to the Immigration and Nationality Act's visa and labor certification requirements. The amended compacts' implementing legislation, Pub. L. No. 108-188, appropriated $30 million annually for 20 years to help defray affected U.S. jurisdictions' costs for migrant services (compact impact). The amended compacts' implementing legislation defined the affected jurisdictions as Guam, Hawaii, the Commonwealth of the Northern Mariana Islands, and American Samoa. Interior allocates the $30 million as impact grants in proportion to the population of compact migrants enumerated as required every 5 years. The most recent enumeration, conducted by the U.S. Census Bureau, was in 2013 and the next enumeration is ongoing, with results expected in December 2018. In 2016, Interior reported that the U.S. Census Bureau, using 2010-2014 data, estimated that approximately 41,380 citizens from the FSM, RMI and Palau were living in the 50 states. According to a Census enumeration derived from the 2010 Census, an additional 19,830 were living in Guam and the Commonwealth of the Northern Mariana Islands. We have previously reported on compact migration to U.S. areas; see *Compacts of Free Association: Improvements Needed to Assess and Address Growing Migration*, GAO-12-64 (Washington, D.C.: Nov. 14, 2011).

[14]See GAO, *Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development*, GAO/NSIAD-00-216 (Washington, D.C.: Sept. 22, 2000). We reported that FSM and RMI compact funds spent on general government operations maintained high government wages and a high level of public sector employment, discouraging private sector growth, and that compact funds used to create and improve infrastructure likewise did not contribute to significant economic growth.

Amended Compacts of Free Association (2004–Present)

Compact Grants and Trust Fund Contributions

In 2003, following a period of negotiations, the United States approved separate amended compacts with the FSM and the RMI that went into effect on June 25, 2004, and May 1, 2004, respectively.

The amended compacts' implementing legislation authorized and appropriated direct financial assistance to the FSM and the RMI in fiscal years 2004 through 2023, with the base amounts decreasing in most years. The annual decrements in assistance are added to the amounts deposited in the trust funds established under the amended compacts for the two nations.[15] Earnings from the compact trust funds are intended to provide an annual source of revenue after the scheduled end of compact sector grants at the end of fiscal year 2023. Both the compact sector grants and trust fund contributions are partially adjusted for inflation each fiscal year.[16] Appendix II provides additional information on the base and inflation-adjusted amounts of U.S. compact sector grants and trust fund contributions in fiscal years 2004 through 2023.[17]

The amended compacts and associated fiscal procedures agreements require that compact sector grants support the countries in six core sectors—education, health, infrastructure, environment, private sector development, and public sector capacity building—with the education and health sectors having priority. These grants are described in section 211(a) of each compact and are referred to as compact sector grants or

[15]The grant decrement and trust fund increment for the FSM is $800,000 per year; the decrement for the FSM began in 2007. The grant decrement and trust fund increment for the RMI is $500,000 per year; the decrement for the RMI began in 2005. As a result of these differences, final grants to the FSM will decrease from the initial grants by a smaller total percentage than will final grants to the RMI (18 percent versus 21 percent).

[16]The contributions are partially adjusted for inflation by the percentage that equals two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator, or 5 percent, whichever is less in any 1 year, using the beginning of 2004 as a base.

[17]The U.S. contributions to the trust funds were conditioned on the FSM and the RMI making their own required contributions. The FSM was required to contribute at least $30 million before September 30, 2004; the FSM made this contribution on October 1, 2004, and the United States made its first contribution on October 5, 2004. The RMI was required to contribute at least $25 million on the day the amended compact went into effect or on October 1, 2003, whichever was later; $2.5 million before October 1, 2004; and an additional $2.5 million before October 1, 2005. The RMI made its initial contribution on June 1, 2004, and the United States made its initial contribution on June 3, 2004.

211(a) grants.[18] Section 211(b) of the RMI compact further states that the RMI must target a specified amount of grants to Ebeye and other Marshallese communities within Kwajalein Atoll.[19] The RMI MUORA states that the Kwajalein-related funds provided to the RMI in the compacts shall be provided through fiscal year 2023 "and thereafter for as long as this agreement remains in effect."[20]

Compact Trust Fund Management and Implementation

The amended compacts and their subsidiary trust fund agreements provided that each trust fund is to be managed by a compact trust fund committee.[21] Each compact trust fund committee includes representatives from both the United States and the respective country, but the United States is required by the terms of the trust fund agreements to hold the majority of votes on each committee. The Director of Interior's Office of Insular Affairs serves as the chair of each committee. Trust fund committee responsibilities include overseeing fund operation, supervision, and management; investing and distributing the fund's resources; and concluding agreements with any other contributors and other organizations. As part of this oversight, the committees are to establish an investment and distribution policy. The committees are also to determine fiscal procedures to be used in implementing the trust fund

[18]Both compacts also provide annual grants to fund the cost of required annual audits. The amount provided is not adjusted for inflation and is equal to the lesser of (1) one half of the cost of the annual audit or (2) $500,000.

[19]In addition, RMI compact section 212 provides a partially inflation-adjusted $15 million annually starting in 2004, rising to $18 million in 2014, and partially inflation adjusted thereafter, for U.S. military use and operating rights. The RMI government uses the section 212 funds to compensate landowners on the Kwajalein Atoll.

[20]*Compact of Free Association Military Use and Operating Rights: Agreement between the United States and the Marshall Islands, Signed at Majuro April 30, 2003, with Agreed Minutes and Annexes and Related Agreement Effected by Exchange of Letters, March 23, 2004*. The agreement extends until 2066, and the United States may renew it for an additional 20 years to 2086. The United States may terminate the RMI MUORA after 2023 with 7 years advance notice. If termination occurs prior to 2053, the United States is required to make a termination payment equivalent to 1 or more years of annual grant assistance.

[21]The amended compacts' implementing legislation required the trust funds to be established as nonprofit corporations incorporated under the laws of the District of Columbia.

agreements based on the fiscal procedures used for compact grant administration unless otherwise agreed by the parties to the agreement.[22]

The trust fund agreements between the United States and the FSM and the RMI allow for the agreements to be amended in writing at any time, with mutual consent of the governments. However, the U.S. legislation implementing the amended compacts requires that any amendment, change, or termination of all or any part of the compact trust fund agreements shall not enter into force until incorporated into an act of Congress.

According to the trust fund agreements, each trust fund committee is to appoint a trustee and an independent auditor.[23] Each committee has retained an Executive Administrator to manage the daily operations of the trust fund. In addition, the committee has the authority to appoint 1 or more investment advisers and may enter into a separate agreement with 1 or more money managers. The investment policy statement for each fund guides the fund's investment strategy and portfolio.[24]

Compact Trust Fund Structure

The compact trust fund agreements state that no funds, other than specified trust fund administrative expenses, may be distributed from the compact trust fund prior to October 1, 2023. From fiscal year 2024 onward, the maximum allowed disbursement from each compact trust fund is the amount of the fiscal year 2023 annual grant assistance, as defined by the trust fund agreement, with full adjustment for inflation.[25]

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[22]The committees are also responsible for publishing annual reports on the trust funds within 6 months after the end of each fiscal year that describe the activities and management of the funds and contain audited account information and required audit reports. The reports are also to assess the effectiveness of the funds in contributing to the economic advancement and long-term budgetary self-reliance of the FSM and RMI and may include recommendations to improve the funds' effectiveness.

[23]According to U.S. officials, in practice, the trust fund committees have used custodians instead of trustees, with some of the responsibilities envisioned for the trustee role given instead to the fund administrator or retained by the committees.

[24]Each compact trust fund maintains a portfolio of assets, such as bonds, stocks, or other holdings. Investment strategies vary in their levels of returns and volatility. A more conservative investment strategy usually carries a lower level of volatility but also brings lower expected returns over time; a more aggressive investment strategy seeks higher returns but is likely to have higher volatility, with returns on the investment varying more widely year to year. By varying the weight of each investment asset, investors can vary their return and risk levels.

[25]Full inflation is defined as the full percent change in the United States GDP implicit price deflator in the applicable fiscal year compared to the immediate preceding fiscal year.

In addition, the trust fund committees may approve additional amounts for special needs.[26] The RMI compact trust fund agreement excludes from the calculation of the allowed disbursement the amount of the Kwajalein-related assistance defined in section 211(b) of the RMI compact. Although the compact trust fund agreements state the maximum allowable disbursement level, they do not establish or guarantee a minimum disbursement level.

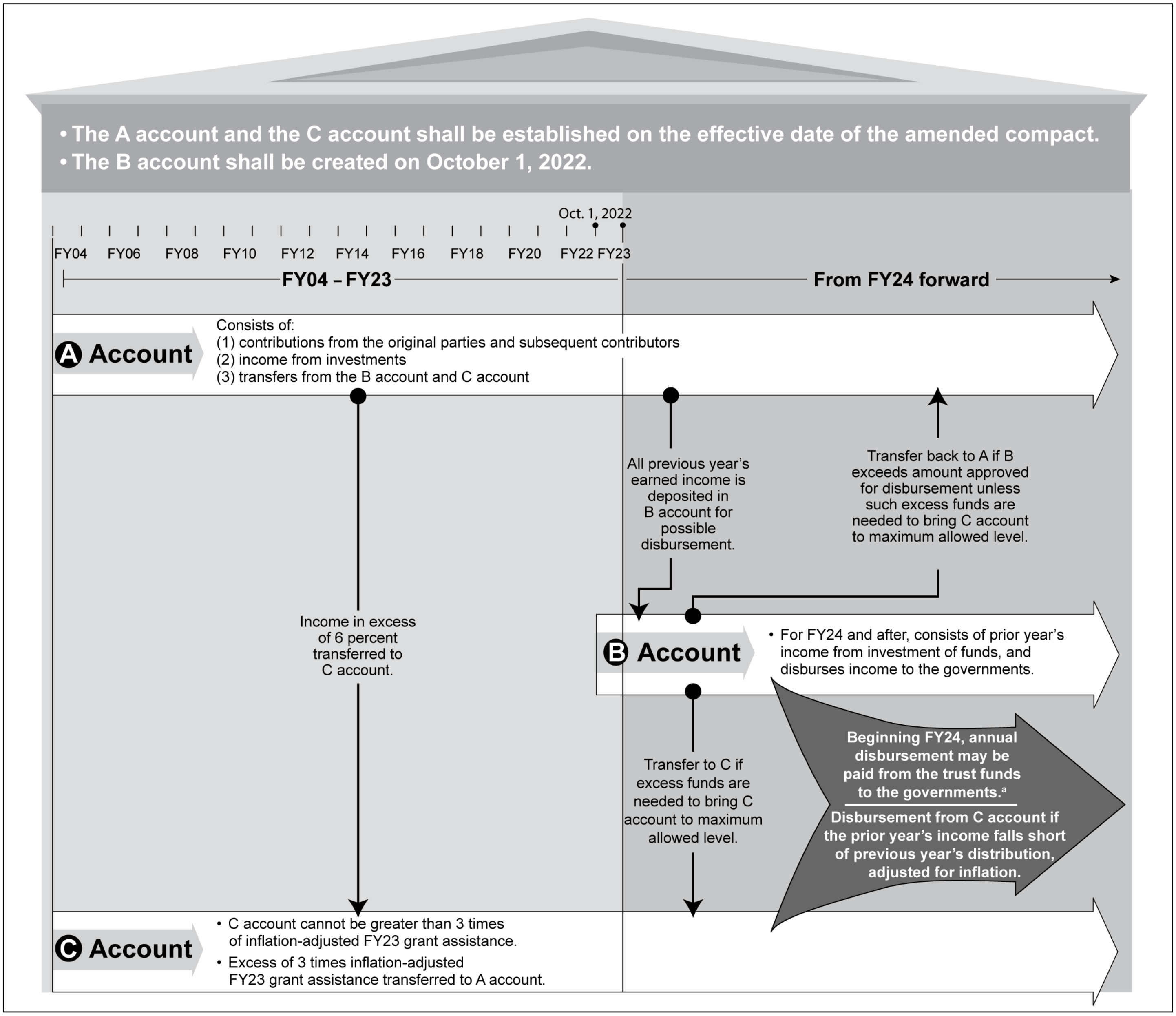
Each country's compact trust fund consists of three interrelated accounts: the "A" account, the "B" account, and the "C" account.

- The A account is the trust fund's corpus and contains the initial, and any additional, U.S. and FSM or RMI contributions; contributions from other countries; and investment earnings. No funds, other than specified trust fund administrative expenses, may be disbursed from the A account.
- The B account is the trust fund's disbursement account and becomes active in fiscal year 2023. All income earned in 2023 will be deposited in the B account for possible disbursement in 2024. Each subsequent year's investment income will similarly be deposited into the B account for possible disbursement the following year. If there is no investment income, no funds will be deposited in the B account for possible disbursement the following year.
- The C account is the trust fund's buffer account. Through 2022, any annual income exceeding 6 percent of the fund balance is deposited in the C account. From 2023 onward, if annual income from the A account is less than the previous year's disbursement, adjusted for inflation, the C account may be tapped to address the shortfall. After 2023, any funds in the B account in excess of the amount approved for disbursement the following fiscal year are to be used to replenish the C account as needed, up to the maximum size of the account. The size of the C account is capped at three times the amount of the estimated annual grant assistance in 2023, including estimated inflation. If there are no funds in the C account, and no prior year investment income in the B account, no funds will be available for disbursement to the countries the following year.

[26]Special needs are defined as projects that the government of the FSM or RMI deems necessary as a supplement to that portion of an annual budget to be financed by the compact trust funds, so long as the projects are for the purposes of Section 211 of the compact, as amended.

Figure 2 shows the compact trust fund account structure and associated rules.

Figure 2: Account Structure and Associated Rules for Federated States of Micronesia and Republic of the Marshall Islands Compact Trust Funds



[a]Annual disbursement is limited to inflation-adjusted annual grant assistance in FY23, plus any amounts for special needs approved by the Trust Fund Committee.

Source: GAO analysis of the Federated States of Micronesia and Republic of the Marshall Islands Compact Trust Fund Agreements. | GAO-18-415

According to the U.S. trust fund agreements with the FSM and the RMI, contributions from other donors are permitted. In May 2005, Taiwan and the RMI reached an agreement that Taiwan will contribute a total of $40 million to the RMI's compact trust fund A account between 2004 and 2023.[27] A "D" account may also be established to hold any contributions by the FSM and the RMI governments of revenue or income from unanticipated sources. According to the trust fund agreements, the D account must be a separate account, not mixed with the rest of the trust fund. Only the RMI has a D account, governed in part by an agreement between Taiwan and the RMI.

Compact Accountability, Management Structures, and Reporting

The amended compacts' implementing legislation and their subsidiary fiscal procedures agreements established committees to oversee compact grants to each country—the Joint Economic Management Committee (JEMCO) for the FSM and the Joint Economic Management and Financial Accountability Committee (JEMFAC) for the RMI. Each five-member committee comprises three representatives from the U.S. government and two representatives from the corresponding country, with the Director of Interior's Office of Insular Affairs serving as the chair.

JEMCO's and JEMFAC's designated roles and responsibilities include the following:

- reviewing the budget and development plans from each of the governments;
- approving grant allocations and performance objectives;
- attaching terms and conditions to any or all annual grant awards to improve program performance and fiscal accountability;
- evaluating progress, management problems, and any shifts in priorities in each sector; and
- reviewing audits called for in the compacts.

JEMCO and JEMFAC can require that terms and conditions be attached to any and all annual compact sector grant awards to improve program

[27] As a result of its contributions, and approval by the trust fund committee, Taiwan has a representative on the RMI compact trust fund committee. When Taiwan's representative was added to the committee, U.S. representation was increased by one to ensure a continued U.S. majority on the committee. According to U.S. officials, the RMI and Taiwan have discussed increasing Taiwan's contribution to $3 million per year until 2023 and providing additional contributions after that time. However, according to RMI officials, these discussions have not been finalized.

performance and fiscal accountability. Under the fiscal procedures agreements governing the amended compacts, the Office of Insular Affairs is responsible for using financial reports to monitor each country's budget and fiscal performance and for using performance reports submitted by the countries to evaluate sector grant performance. The FSM and the RMI also must adhere to specific fiscal control and accounting procedures and are required to submit annual audit reports, within the meaning of the Single Audit Act as amended.[28]

The FSM and RMI compacts require each country to develop multiyear plans that are strategic in nature and continuously reviewed and updated through the annual budget process and that address the assistance for the defined sectors. In 2013, we recommended that Interior, as Chair of JEMCO and JEMFAC, ensure that the FSM and the RMI complete plans to address the impact of declining compact sector grants (in this report, decrement management plans).[29] In November 2013, the FSM finalized its decrement management plan for fiscal years 2014 through 2023; the plan indicated that a similar planning process is to be repeated in 3-year intervals.[30] In September 2014, the RMI finalized its decrement management plan for fiscal years 2015 through 2023; the plan similarly stated that a comprehensive planning process to address the ongoing decrement may proceed on a 3-year update schedule.[31] Each decrement management plan includes commitments for budget reductions in the national governments and, in the FSM, the state governments, as well as plans to undertake actions such as tax reform.

[28]Pub. L. No. 98-502 as amended and codified at 31 U.S.C. § 7501 et seq. Single audits are focused on recipients' internal controls over financial reporting and compliance with laws and regulations governing U.S. federal awardees and provide key information about the federal grantee's financial management and reporting. According to the act, single audit reports are due to the Federal Audit Clearinghouse within 9 months after the end of the audited period. The threshold for requiring single audit reports is expenditure of federal award money greater than $750,000 in any given year.

[29]GAO, *Compacts of Free Association: Micronesia and the Marshall Islands Continue to Face Challenges Measuring Progress and Ensuring Accountability*, GAO-13-675 (Washington, D.C.: Sept. 20, 2013).

[30]Government of the Federated States of Micronesia, *FSM-Wide Long-Term Fiscal Framework, FY2014-FY2023* (November 2013).

[31]Republic of the Marshall Islands, *Decrement Management Plan, FY2015-FY2023* (Sept. 3, 2014).

Programs and Services Provided in Compact-Related Agreements

The amended compacts' implementing legislation incorporates by reference related agreements extending programs and services to the FSM and RMI. The programs and services agreement with each country identifies the following programs and services as being available to each country: U.S. postal services, weather services, civil aviation, disaster preparedness and response, and telecommunications.[32] Each programs and services agreement extends for 20 years from the compact's entry into force. Therefore, the agreement with the FSM ends on June 24, 2024, and the agreement with the RMI ends on April 30, 2024.

Programs Authorized by U.S. Legislation

The amended compacts' implementing legislation (Pub. L. No. 108-188) and other U.S. legislation authorize other U.S. grants, programs, and services for the FSM and RMI. Pub. L. No. 108-188 authorized an annual supplemental education grant (SEG) for the FSM and RMI in fiscal years 2005 through 2023, to be awarded in place of grants formerly awarded to the countries under several U.S. education, health, and labor programs. The FSM and RMI are not eligible for the programs replaced by the SEG during these years.[33] Unlike the compact sector grants, the amended compacts' implementing legislation authorized the SEG but did not appropriate funds for it. Funding for the SEG is appropriated annually to the U.S. Department of Education (Education) and transferred to Interior for disbursement. Other provisions of the amended compacts' implementing legislation, as well as other U.S. law, make the FSM and RMI eligible for a number of additional programs. Other federal departments are responsible for the administration and oversight of their respective programs in the FSM and RMI.

[32]The FSM programs and services agreement additionally makes the services of the Federal Deposit Insurance Corporation available in the FSM to provide deposit insurance for the Bank of the Federated States of Micronesia.

[33]The amended compacts' implementing legislation authorized annual appropriations of about $12.2 million for the FSM and $6.1 million for the RMI, adjusted for inflation, beginning in 2005. Permitted uses of the SEG include, among other things, support for direct educational services at the local school level focused on school readiness, early childhood education, primary and secondary education, vocational training, adult and family literacy, and the smooth transition of students from high school to postsecondary educational pursuits or rewarding career endeavors. In fiscal year 2017, $16.7 million was appropriated to the Secretary of Education for the SEG: $11.1 million for the FSM and $5.6 million for the RMI. In each country, this amount is lower than the authorized SEG amount and is also lower than the authorized amount after inflation adjustments.

The FSM and RMI Continue to Rely on U.S. Grants and Programs That End in 2023

Compact sector grants and the SEG, each of which end in 2023, continue to support a substantial portion of government expenditures in the FSM and RMI. In the FSM, compact sector grants and the SEG support about one-third of all government expenditures. The four FSM states rely on these grants to a greater extent than the FSM national government does. In the RMI, compact sector grants and the SEG support about one-quarter of all government expenditures. The end of the compacts' programs and services agreements in 2024 would also require the FSM and RMI to bear additional costs to provide services currently provided by the United States as part of the Agreements. Appendix IV provides a detailed summary of programs and services we identified that have been provided through the amended compacts, the amended compacts' implementing legislation, compact-related agreements, and other provisions of U.S. law, as well as their status in the FSM and RMI after 2023.[34]

U.S. Compact Grants and Other Grants Continue to Provide Substantial Support to the FSM and RMI Budgets

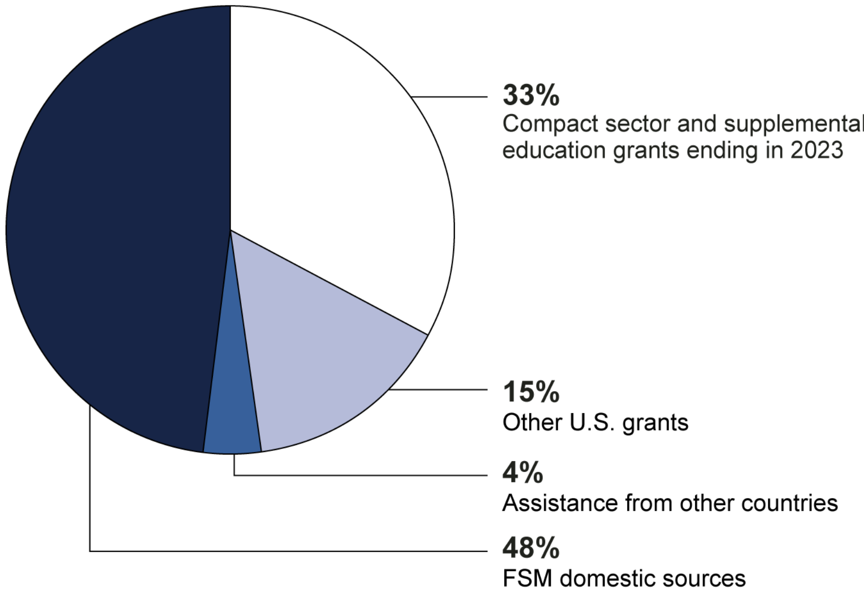
U.S. Grants Scheduled to End in 2023 Support About One-Third of Total FSM Government Expenditures

The FSM national and state governments overall continue to rely on U.S. support for program expenditures. Compact sector grants, the SEG, and other U.S. grants supported almost half of FSM national and state government expenditures in fiscal year 2016.[35] Compact sector and supplemental education grants that end in 2023 supported approximately one-third of total FSM national and state government expenditures in fiscal year 2016, while other U.S. grants supported an additional 15 percent of total FSM government expenditures (see fig. 3).

[34]Throughout this report, we present conclusions about the status of grants and programs under current U.S. law. Changes to the relevant laws prior to 2023 could change the eligibility status of the FSM and RMI. The availability of some grants and programs in the future is subject to the availability of appropriations provided for that purpose.

[35]FSM national government and state government component unit utilities also used compact sector grants to support their expenditures in fiscal years 2012 through 2016. Compact sector grants supported approximately 10 percent of the Chuuk Public Utility Corporation's $6.2 million in average annual operating expenditures and approximately 80 percent of its $15.9 million in total capital improvements expenditures. Utilities in the other three FSM states used compact sector grants to a lesser extent.

Figure 3: Total Expenditures of Federated States of Micronesia (FSM) National and State Governments, by Revenue Source, Fiscal Year 2016



Source: GAO analysis of P.L. 108-188 and FSM single audit reports. | GAO-18-415

Notes: The percentages shown do not include government component units, such as public utilities and port authorities. While the supplemental education grant ends in 2023, the FSM would be eligible for some of the programs that the supplemental education grant replaced after 2023. A small number of other U.S. grants also end in 2023. See GAO-18-415, app. IV for a discussion of grants and programs that do and do not end in 2023.

FSM States Rely on U.S. Grants Scheduled to End in 2023 to a Greater Extent than the National Government

Compact sector and supplemental education grants that end in 2023 support a larger proportion of FSM state governments' expenditures than of the FSM national government's expenditures. In fiscal year 2016, compact sector grants and the SEG supported 8 percent of national government expenditures but supported 50 percent or more of each state's government expenditures. Among the FSM states, Chuuk—both the largest state and the state with the lowest per capita income in the FSM—has the highest percentage of its expenditures supported by U.S. grants. (See table 2 for a summary of FSM national and state government expenditures supported by compact sector grants and the SEG, and by other U.S. grants.) Compact sector grants and the SEG support an even higher proportion of FSM states' health and education expenditures. See app. III for a summary of the role of compact funds in the FSM health and education sectors.

Table 2: FSM National and State Government Expenditures of Compact Grants, Supplemental Education Grant (SEG), and Other U.S. Grants in Fiscal Year 2016

Dollars in millions

		Expenditures of compact sector grants and SEG[a]		Expenditures of other U.S. grants		Total expenditures of compact sector, SEG, and other U.S. grants	
	Total government expenditures (dollars)	Amount (dollars)	Percentage of total government expenditures	Amount (dollars)	Percentage of total government expenditures	Amount (dollars)	Percentage of total government expenditures
FSM national government	103.6	8.1	8	21.0	20	29.1	28
FSM states							
Chuuk	37.3	26.6	71	2.0	5	28.6	76
Kosrae	14.0	6.9	49	1.7	12	8.6	61
Pohnpei	33.0	16.5	50	3.0	9	19.5	59
Yap	20.1	10.3	51	2.5	12	12.8	63
Total	**208.0**	**68.4**	**33**	**30.2**	**15**	**98.6**	**48**

Source: GAO analysis of FSM national government and state fiscal year 2016 single audit reports. | GAO-18-415

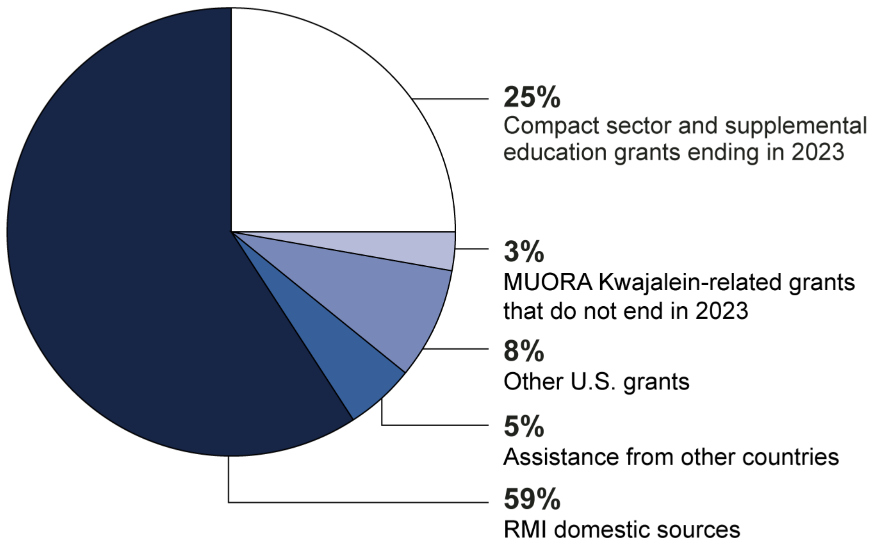
[a]The amounts and percentages shown do not include FSM national and state government component units, such as public utilities and port authorities.

U.S. Grants Scheduled to End in 2023 Support About One Quarter of RMI Government Expenditures

The RMI continues to rely on U.S. support for program expenditures. Compact sector and supplemental education grants that end in 2023 supported approximately 25 percent of the RMI's $123.5 million in government expenditures in fiscal year 2016, while other U.S. grants supported an additional 8 percent.[36] Compact Kwajalein-related grants that do not end in 2023 supported an additional 3 percent (see fig. 4). Compact sector grants and the SEG support an even higher proportion of RMI health and education expenditures. See app. III for a summary of the role of compact funds in the RMI health and education sectors.

[36]RMI government component unit utilities also used compact sector grants to support their expenditures in fiscal years 2012 through 2016. Compact sector grants provided more than half of the average $909,000 in total revenues of the Majuro Atoll Waste Corporation, which provides sanitation services, and 13 percent of the Majuro Water and Sewer Company's annual average of $1.6 million in revenues and capital contributions. Kwajalein-related compact grants supported approximately 20 percent of the $8.6 million in annual average expenditures of Kwajalein Atoll Joint Utilities Resources, the utility provider for Ebeye.

Figure 4: Total Expenditures of RMI Government, by Revenue Source, Fiscal Year 2016



Source: GAO analysis of P.L. 108-188, the Republic of the Marshall Islands (RMI) Military Use and Operating Rights Agreement (MUORA); and RMI single audit reports. | GAO-18-415

Notes: The percentages shown do not include government component units, such as public utilities and port authorities, and do not include the $18 million annually, partially inflation adjusted, provided to the RMI government that the RMI government uses to compensate Kwajalein Atoll landowners for U.S. access to the atoll. While the supplemental education grant ends in 2023, the RMI would be eligible for some of the programs that the supplemental education grant replaced after 2023. A small number of other U.S. grants also end in 2023. See GAO-18-415, app. IV for a discussion of grants and programs that do and do not end in 2023.

End of the Programs and Services Agreements Would Also Affect FSM and RMI Budgets

FSM and RMI budgets would be affected if the countries were to assume responsibility for providing some additional programs and services currently provided by the United States.[37] Current U.S. law enables U.S. agencies to continue providing some programs and services now provided under the agreements after they end in 2024. However, under current law, some programs and services provided in the programs and services agreements will end and would require the FSM and RMI to bear additional costs. See appendix IV for a summary of the status of programs and services provided under the programs and services agreements after the agreements end.

[37]For example, absent the programs and services agreement, the FSM and RMI would have to bear costs associated with the transportation of mail to and from each country—a service currently provided by the U.S. Postal Service—and the Federal Aviation Administration would seek reimbursement for the technical assistance that is currently provided under the agreement.

Compact Trust Funds Face Continuing Risks That Trust Fund Committees Have Not Yet Addressed

Previous studies of the FSM and RMI compact trust funds, including a review we conducted in 2007, found that after fiscal year 2023 the funds are unlikely to provide maximum annual disbursements, may provide no disbursements at all in some years, and are unlikely to sustain the funds' fiscal year 2023 value. Our updated projections for the compact trust funds show similar outlooks. Several potential strategies could improve the compact trust funds' outlook; some of these strategies could be implemented under the current trust fund agreements, while other strategies may require changing the trust fund agreements. The compact trust fund committees have not yet prepared distribution policies, required by the trust fund agreements, that could assist the countries in planning for the transition to trust fund income. In addition, the committees have not established fiscal procedures for oversight of compact trust fund disbursements as required by the trust fund agreements. Further, the trust fund committees have not yet addressed a potential misalignment between the timing of their annual calculation of the amounts available to disburse and the FSM's and RMI's budget timelines, potentially complicating each country's planning and management.

Previous Studies of Compact Trust Funds Found Increasing Risks to Disbursements and Sustainability under Current Rules

Previous studies of the compact trust funds have found that some yearly disbursements from the funds after 2023 are likely to fall short of the inflation-adjusted amount of annual grant assistance in 2023 and that the funds may provide no disbursement at all in some years. Our 2007 analysis of the compact trust funds projected a wide range of potential balances and found that the funds' capacity to provide the maximum allowable disbursement would likely decrease over time.[38] In addition, our analysis showed an increasing likelihood that the trust funds would exhaust the C account and be unable to provide any disbursements in the latter years of our projection.[39] Other analyses have similarly found risks of low or zero disbursements and risks to sustainability.

[38]The existing compact trust fund agreements set the maximum disbursement as the inflation-adjusted amount of annual grant assistance, as defined by the trust fund agreement, in fiscal year 2023. The relevant trust fund committee may also approve additional amounts for special needs. Special needs are defined as projects that the government of the RMI or of the FSM deems necessary as a supplement to that portion of an annual budget to be financed by the compact trust funds, so long as the projects are for the purposes stated in section 211 of the compact, as amended.

[39]GAO-07-513.

- Graduate School USA has prepared an annual series of economic reports on each country, including analyses of their compact trust funds.[40]
- In 2015, an Asian Development Bank report separately analyzed the trust funds.[41]
- The International Monetary Fund projected the status of the trust funds as part of its biennial FSM and RMI consultations.[42]

Updated Projections Show Continuing Risks to Compact Trust Fund Disbursements and Sustainability

Our updated projections for the FSM and RMI compact trust funds after 2023 indicate a continued likelihood that, given their balance at the end of fiscal year 2017[43] and current compact trust fund rules—the baseline scenario—the funds will be

- unable to provide maximum disbursements (equal to the inflation-adjusted amount of annual grant assistance in 2023) in some years;[44]
- unable to provide any disbursement at all in some years, with the likelihood of zero disbursement in a given year increasing over time; and

[40]Graduate School USA's most recent annual economic reports are *FSM FY2016 Economic Brief* and *RMI FY2016 Economic Brief*, both published in August 2017. Reports in prior years provided greater detail and analysis of the compact trust funds, including potential strategies for improving their outlooks. For example, see Graduate School USA, *Federated States of Micronesia Fiscal Year 2015 Economic Review,* October 2016; and *Republic of the Marshall Islands Fiscal Year 2015 Economic Review* (October 2016).

[41]Asian Development Bank, *Trust Funds and Fiscal Risks in the North Pacific: Analysis of Trust Fund Rules and Sustainability in the Marshall Islands and the Federated States of Micronesia* (Manila, Philippines: 2015).

[42]The most recent such reports are International Monetary Fund, *Federated States of Micronesia: Staff Report for the 2017 Article IV Consultation* (Washington, D.C.: Aug. 4, 2017); and *Republic of the Marshall Islands: Staff Report for the 2016 Article IV Consultation* (Washington, D.C.: Jul. 7, 2016).

[43]As of September 30, 2017, the FSM compact trust fund had an unaudited balance of $565 million and the RMI compact trust fund had an unaudited balance of $357 million.

[44]The relevant trust fund committee may also approve additional funds for special needs, as defined in the compact trust fund agreement. We did not estimate or project the amount of funds approved for disbursements as special needs as part of our analysis. Disbursing additional funds for special needs will, in subsequent years, decrease the likelihood of maintaining maximum disbursements, increase the likelihood of zero disbursements, and decrease the likelihood that the fund maintains its inflation-adjusted value.

- unable to maintain the inflation-adjusted value of the compact trust fund after fiscal year 2023.[45]

The compact trust funds' C account—designed as a buffer to protect disbursements from the B account in years when the funds do not earn enough to fund the disbursement—could be exhausted by a series of years with low or negative annual returns. Since current rules do not allow disbursements from the compact trust fund corpus (the A account), exhaustion of the C account would result in zero disbursement in years when fund returns are zero or negative.[46] Thus, there may be no funds available to disburse even if the funds' A accounts have a balance. As a result of low or zero disbursements, the countries could face economic and fiscal shocks and significant challenges in planning programs and budgets.

FSM Compact Trust Fund Projections

Our model projects that, given the baseline scenario and a 6 percent net return, the FSM compact trust fund will experience declining disbursements relative to the maximum allowable disbursements; an increasing chance of zero disbursements; and a declining likelihood of maintaining its 2023 balance. See appendix I for a full description of our methodology and appendix V for the baseline results with alternative net returns.[47]

- **Projected disbursements**. We project that the FSM compact trust fund will, on average, be able to provide disbursements equal to 82 percent of the maximum allowable disbursement—the inflation-

[45]Our median projection of the compact trust funds' balance in fiscal year 2024 before any disbursements is $1.02 billion for the FSM compact trust fund and $644 million for the RMI compact trust fund.

[46]Because, like the A account, the C account can earn investment income, reductions in the C account would reduce both the value of the trust fund and the potential amount of future trust fund earnings.

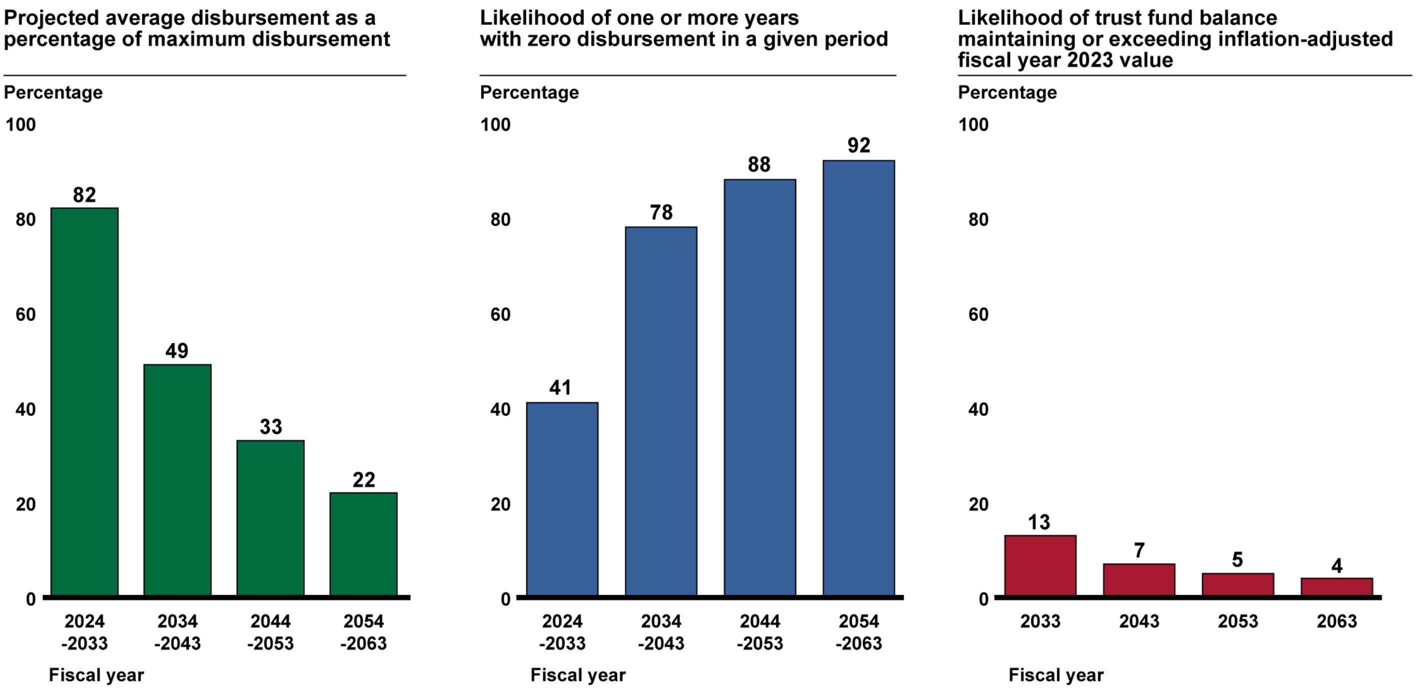
[47]We selected the 6 percent projected net rate of return on the basis of our review of the capital market assumptions and projections used by the money managers for the compact trust funds as well as historical market rates of return. The model approximates a projection based on our set of assumptions and may differ with varying conditions. In addition to projecting the compact trust fund disbursements and balance on the basis of a 6 percent net return, we estimated the trust fund baseline on the basis of alternative return assumptions of 5 percent, 7 percent, and 8 percent. These varying assumptions also show a likelihood that available compact trust fund disbursements will not reach an amount equivalent to maximum disbursements permitted by the compact trust fund agreement, continuing risk of zero disbursements, and decreasing likelihood that the fund will maintain or exceed its inflation-adjusted balance in fiscal year 2023.

adjusted amount of 2023 annual grant assistance—in its first decade of disbursements. The likely average disbursement falls to 49 percent of the maximum in the next decade and falls further in subsequent decades. In addition, the amount available for disbursement may fluctuate substantially from year to year. Depending on the compact trust fund's performance in the previous year, disbursements may be higher or lower than the average amount if the balance in the C account is not sufficient to provide additional disbursements.

- **Likelihood of providing zero disbursement.** We project a 41 percent likelihood that the FSM compact trust fund will be unable to disburse any funds in 1 or more years during the first decade of trust fund disbursements. This likelihood increases over time, rising to 92 percent in fiscal years 2054 through 2063.
- **Likelihood of maintaining inflation-adjusted 2023 balance.** We project a 13 percent likelihood that the FSM compact trust fund will maintain or exceed its inflation-adjusted fiscal year 2023 value in fiscal year 2033. This likelihood decreases in later years.

Figure 5 shows our projections of the FSM compact trust fund's average disbursements as a percentage of maximum disbursement, the likelihood of 1 or more years of zero disbursement, and the likelihood of the fund's maintaining its inflation-adjusted fiscal year 2023 balance given the baseline scenario and a 6 percent net return.

Figure 5: Projected FSM Compact Trust Fund Average Disbursements, Likelihood of Zero Disbursements, and Likelihood of Maintaining Inflation-Adjusted Fiscal Year 2023 Balance, Fiscal Years 2024-2063



Source: GAO analysis of Federated States of Micronesia (FSM) compact trust fund documents. | GAO-18-415

Notes: The projections shown are based on the current trust fund rules and the compact trust fund's unaudited balance at the end of fiscal year 2017. We assumed that the trust fund's annual net return will have a normal distribution with a mean of 6 percent and a standard deviation of 13 percent.

We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging, over each 10-year period and over 10,000 simulated cases, the ratio of simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given period.

We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement in each of the given periods over 10,000 simulated cases.

We calculated the likelihood that the fund balance will maintain its inflation-adjusted fiscal year 2023 value by simulating 10,000 cases and counting those in which the simulated balance does not equal or exceed the projected inflation-adjusted 2023 balance.

The FSM also maintains its own trust fund separate from the compact trust fund (see app. VI for additional information). We did not independently project the FSM Trust Fund's future balance or potential disbursements after 2023.

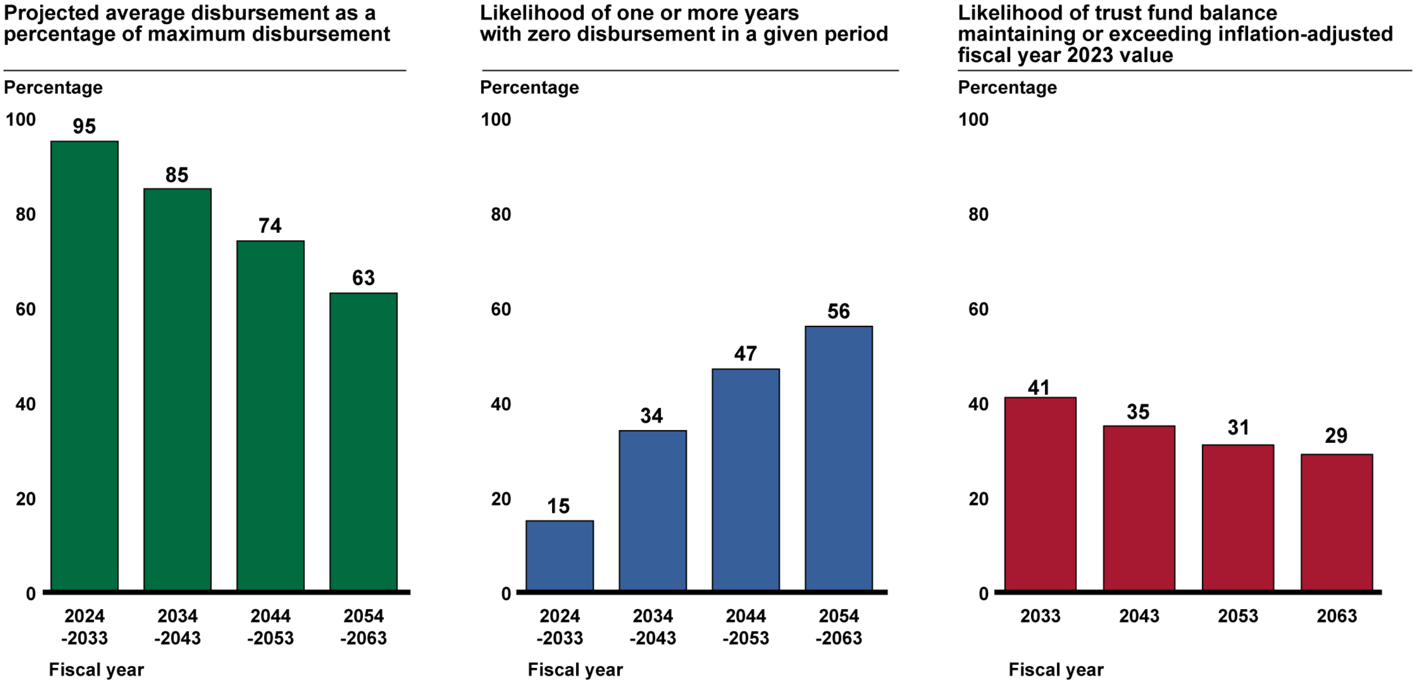
RMI Compact Trust Fund Projections

Our model projects that, given the baseline scenario and a 6 percent net return, the RMI compact trust fund will experience declining disbursements relative to the maximum allowable disbursements; an increasing chance of zero disbursements; and a declining likelihood of sustaining its 2023 balance.

- **Projected disbursements**. We project that the RMI compact trust fund will, on average, be able to provide disbursements nearly equal to the inflation-adjusted amount of 2023 annual grant assistance as defined by the trust fund agreement—the maximum allowable—in its first decade of disbursements. However, the projected disbursements as a percentage of the maximum disbursements decline by about 10 percentage points in each subsequent decade. In addition, the amount available to disburse may fluctuate substantially from year to year. Depending on the compact trust fund's performance in the previous year, disbursements may be higher or lower than the average amount if the balance in the C account is not sufficient to provide additional disbursements.
- **Likelihood of providing zero disbursement.** We project a 15 percent likelihood that the RMI compact trust fund will be unable to disburse any funds in 1 or more years during the first decade of trust fund disbursements. This likelihood increases over time, rising to 56 percent in fiscal years 2054 through 2063.
- **Likelihood of maintaining inflation-adjusted 2023 balance.** We project a 41 percent likelihood that the RMI compact trust fund will maintain or exceed its inflation-adjusted fiscal year 2023 value in fiscal year 2033. This likelihood decreases in later years.

Figure 6 shows our projections of the RMI compact trust fund's average disbursements as a percentage of maximum disbursement, its likelihood of 1 or more years of zero disbursement, and its likelihood of maintaining its inflation-adjusted fiscal year 2023 balance given the baseline scenario and a 6 percent net return.

Figure 6: Projected RMI Compact Trust Fund Average Disbursements, Likelihood of Zero Disbursements, and Likelihood of Maintaining Inflation-Adjusted Fiscal Year 2023 Balance, Fiscal Years 2024-2063



Source: GAO analysis of Republic of the Marshall Islands (RMI) compact trust fund documents. | GAO-18-415

Notes: The projections shown are based on the current trust fund rules and the compact trust fund's unaudited balance at the end of fiscal year 2017. We assumed that the trust fund's annual net return will have a normal distribution with a mean of 6 percent and a standard deviation of 13 percent.

We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging, over each 10-year period and over 10,000 simulated cases, the ratio of simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given period.

We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement in each of the given periods over 10,000 simulated cases.

We calculated the likelihood that the fund balance will maintain its inflation-adjusted fiscal year 2023 value by simulating 10,000 cases and counting those in which the simulated balance does not equal or exceed the projected inflation-adjusted 2023 balance.

The RMI also maintains its own D account separate from the compact trust fund (see app. VI for additional information). We did not independently project the D account balance or potential disbursements from the D account after 2023.

Reducing Disbursements, Making Additional Contributions, and Changing Disbursement Policies Would Each Affect the Outlook of the Compact Trust Funds

We conducted a series of simulations to determine the likely effects of potential strategies for improving the outlook of the FSM and RMI compact trust funds. Prior studies by Graduate School USA, the Asian Development Bank, and the International Monetary Fund examined the effects of three general approaches for improving the trust funds' outlooks: (1) reducing planned disbursements from the funds, (2) making additional contributions to the funds, and (3) changing the compact trust fund disbursement policies.[48] These prior studies included strategies that would require changing the trust fund agreements to permit disbursements from the A account. To isolate the impact of individual changes on compact trust fund balance and disbursements, we developed and analyzed five potential strategies based on the approaches examined in the prior studies.[49]

1. Annual disbursements are reduced below the maximum allowable disbursement.
2. Additional annual contributions are made to the trust fund in fiscal years 2018 through 2023.
3. The trust fund agreement disbursement policies are modified to limit the annual disbursement to a fixed percentage of the fund's moving average balance over the previous 3 years, up to the maximum disbursement amount defined by the current trust fund agreement.[50]
4. The trust fund agreement disbursement policies are modified to reduce the amount of the annual disbursement if the compact trust

[48]Each study did not examine every strategy. In practice, these strategies could be implemented in combination. For example, the compact trust funds could both receive additional contributions and have reduced disbursements.

[49]The amounts of disbursement reductions and additional contributions varied among the strategies examined in prior studies. We analyzed different amounts of disbursement reductions and trust fund contributions. See appendix VII for results of our analyses.

[50]A moving average balance is continually recomputed as new data become available. For example, the moving average balance at the end of fiscal year 2024 would average the balances at the end of fiscal years 2022, 2023, and 2024. The following year, the moving average balance would average the balances at the end of fiscal years 2023, 2024, and 2025, and so on.

fund's moving average balance over the previous 5 years is lower than a primary target amount.[51]

5. The trust fund agreement disbursement policies are modified to set the target disbursement as 2.1 percent of the compact trust fund's balance in fiscal year 2024.[52] The disbursement amount is further decreased if the fund's moving average balance over the previous 5 years is lower than the primary target balance.[53]

[51]This strategy is based on the Moving Adjustment Rule (MAR), developed by Graduate School USA. We developed this strategy using the technical description of the moving adjustment rule in Graduate School USA's fiscal year 2014 Economic Review reports. Graduate School USA has continued to revise its model and, in April 2018, issued a compact trust fund analysis that uses 3-year moving averages instead of 5-year moving averages. See Graduate School USA, *Compact Trust Funds in the Freely Associated States: Mechanics and Stochastic Projections* (Honolulu, Hawaii; April 2018). The primary target is defined by Graduate School USA and refers to a conservative benchmark for the value of the compact trust fund that is required to yield the target disbursement at a given rate of return. In Graduate School USA's analysis, the primary target is determined by dividing the target disbursement (the maximum allowable disbursement) by the 5 percent historical average long-run real geometric return of a portfolio with a chosen asset allocation. In our analysis, we used a long-run real geometric return of 3.2 percent derived from our assumed nominal arithmetic net return of 6 percent. In both our analysis and Graduate School USA's 2014 analysis, disbursements are reduced by 5 percent if the 5-year moving average fund balance is below the primary target and increased by 2 percent if the ratio of the five-year moving average fund balance divided by the primary target to last year's distribution divided by the target distribution is greater than 1.

[52]This strategy is based on the Sustainability Adjustment for Enhanced Reliability (SAFER) model, developed by Graduate School USA. According to Graduate School USA, the Sustainability Adjustment for Enhanced Reliability is a method that optimizes for a chosen asset allocation's risk and return characteristics. In both Graduate School USA's analysis and our analysis, the initial target disbursement is determined by multiplying the compact trust fund balance in fiscal year 2023 by the long-run real geometric return divided by a constant number (called the sustainability adjustor). For our analysis, we calculated the initial target disbursement percentage on the basis of a 3.2 percent long-run real geometric return and a sustainability adjustor of 1.5. The target disbursement percentage would be higher if the long-run real geometric return were higher and would be lower if the long-run real geometric return were lower. We developed this strategy using the technical description of the sustainability adjustment for enhanced reliability in Graduate School USA's fiscal year 2014 Economic Review reports. Graduate School USA has continued to revise its model and, in April 2018, while our report was out for comment, issued an updated review that uses 3-year moving averages instead of 5-year moving averages and a 1.67 sustainability adjustor instead of 1.5. See Graduate School USA, *Compact Trust Funds in the Freely Associated States: Mechanics and Stochastic Projections* (Honolulu, Hawaii: April 2018).

[53]The primary target balance is determined by dividing the initial target disbursement (2.1 percent of the compact trust fund on the basis of a 6 percent net return) by the long-run real geometric return on the compact trust fund (3.2 percent on the basis of a 6 percent nominal arithmetic net return).

Implementing either of the first two potential strategies would not require any changes to disbursement provisions in the existing trust fund agreement, but implementing any of the remaining three strategies may require such changes. In strategies 3, 4, and 5, we analyzed strategies that would permit disbursement from the A account. Disbursing from the A account would require changing the compact trust fund agreements. The agreements can be amended in writing at any time, with mutual consent of the governments. However, the U.S. legislation implementing the amended compacts requires that any amendment, change, or termination of all or any part of the compact trust fund agreements shall not enter into force until incorporated into an act of Congress.

All of the potential strategies we analyzed would reduce or eliminate the risk of the compact trust funds experiencing years of zero disbursement. However, all of the potential strategies would require the countries to exchange a near-term reduction in resources for more predictable and sustainable disbursements in the longer term. Appendix VII presents the detailed results of our analysis.

Compact Trust Fund Committees Have Not Addressed Issues Related to Distribution Policies, Fiscal Procedures, and Disbursement Timing

Trust Fund Committees Have Not Developed Distribution Policies Required by the Compact Trust Fund Agreements

Under the compact trust fund agreements, each trust fund committee must develop a distribution policy, with the intent that compact trust fund disbursements will provide an annual source of revenue to the FSM and RMI after fiscal year 2023.[54] The trust fund committees could use distribution policies to address risks to each fund's sustainability.[55] For

[54]A distribution is defined as the transfer of funds from the compact trust fund to the government of the FSM or the RMI. This report refers to such transfers as disbursements.

[55]In addition, *Standards for Internal Control in the Federal Government* states that management should identify, analyze, and respond to risks related to achieving defined objectives; risk identification methods may include forecasting, strategic planning, and consideration of deficiencies identified through audits and other assessments. See GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (September 2014).

example, the committees have the discretion to disburse an amount below the established maximum. Our analysis of potential strategies for improving the funds' outlook shows that reducing the size of disbursements would improve each compact trust fund's long-term sustainability. According to interviews with, and documents provided by, the trust funds' administrator, the committees reviewed presentations in 2016, 2017, and early 2018 from the authors of previous studies and fund managers regarding the likely status of the trust funds after 2023 and have also reviewed options for addressing risks to the trust funds' disbursements and sustainability, including changes to disbursement provisions in the compact trust fund agreements. However, as of January 2018, according to the trust funds' administrator, neither committee had developed a distribution policy. Without a distribution policy that provides information about the size of expected disbursements, the FSM and RMI are hampered in their current and ongoing efforts to plan for the potential reduction in U.S. compact assistance after 2023.

Trust Fund Committees Have Not Established Fiscal Procedures Required by Compact Trust Fund Agreements

The compact trust fund committees have not yet established fiscal procedures for compact trust fund disbursements after fiscal year 2023. Each trust fund agreement requires the respective committee to determine the fiscal procedures to be used in implementing the trust fund agreement. The committees are to base their procedures on the compact fiscal procedures agreements, which define the membership and duties of the JEMCO and JEMFAC and single audit report requirements, among other things, unless the parties to the trust fund agreement agree to adopt different fiscal procedures.[56] No compact trust fund disbursements are to be made unless the committee has established such trust fund fiscal procedures.

U.S., FSM, and RMI officials are aware of the need to determine the fiscal procedures that will govern oversight of compact trust fund disbursements. Issues related to future oversight of compact trust fund disbursements have been raised for discussion with U.S. representatives

[56]The compact fiscal procedures agreements extend, unless terminated by mutual consent, for as long as the United States provides (1) compact sector grants; (2) grants provided under section 105(f)(1)(B) of the amended compacts' implementing legislation (which includes the SEG); (3) federal programs and services; or (4) in the case of the RMI, any additional grant assistance, services, or programs. According to U.S. State Department officials, because sector grant funds provided before the end of fiscal year 2023 will likely continue to be used after that date, the JEMCO and JEMFAC will likely continue to exist for a period of time to oversee the use of the previously provided grants.

on JEMCO and JEMFAC.[57] However, according to an RMI representative on the compact trust fund committee, that committee has not discussed fiscal procedures for the compact trust fund disbursements. In addition, FSM officials noted that they were unsure whether the JEMCO or the compact trust fund committees would approve specific projects.[58] Without fiscal procedures in place, the trust fund committees will not be able to provide disbursements and the United States, the FSM, and the RMI will lack clear guidance to ensure oversight for trust fund disbursements.

Trust Fund Committees Have Not Addressed Issues Related to Disbursement Timing

The timing of the trust fund committees' calculation of the amounts available for annual disbursement to the FSM and the RMI does not align with the countries' budget and planning timelines.[59] The amounts available for disbursement in a given fiscal year cannot be determined until each fund's returns have been determined at the end of the prior year. Further, if the disbursement amounts are calculated from audited fund returns as determined by annual audits required by the trust fund agreements, the amounts may not be determined until as late as March 31, 6 months into the fiscal year for which the disbursement is to be provided.[60] However, both the FSM and the RMI government budget

[57]In April 2017, a presentation by Graduate School USA to the committees' U.S. representatives discussed a range of oversight issues and options related to the FSM's and RMI's transition from reliance on compact grants to reliance on compact trust fund disbursements after fiscal year 2023. This presentation discussed whether the compact trust fund disbursements could be considered U.S. grant assistance subject to the fiscal procedures agreement or not considered U.S. grant assistance and therefore not allocated by JEMCO and JEMFAC or subject to their oversight. State officials stated that, whatever the division of responsibilities between JEMCO and JEMFAC and the trust fund committees, the trust fund committees will not be the sole oversight entity for the use of trust fund disbursements. According to the officials, State does not believe it would be appropriate for the trust fund committees, as private, not-for-profit entities, to conduct oversight of the use of funds provided to sovereign governments.

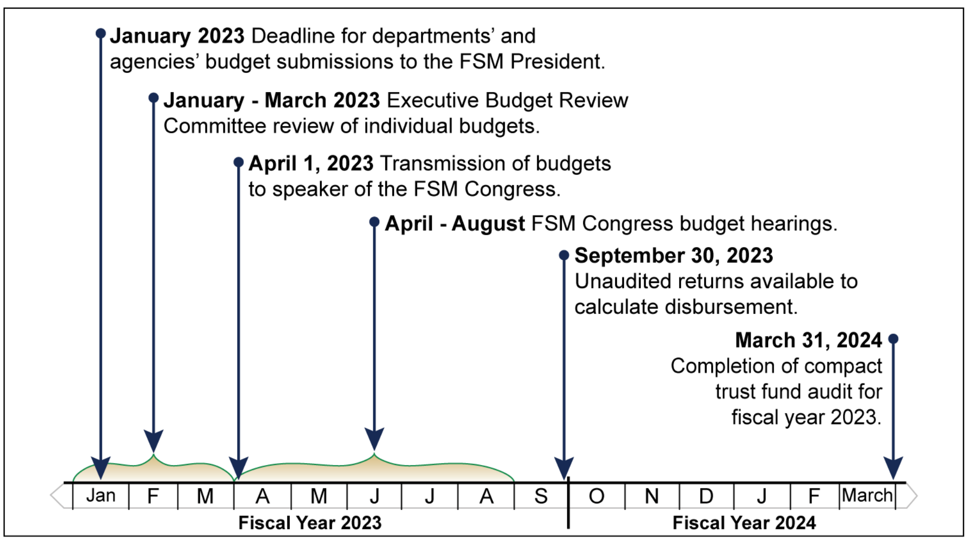
[58]According to FSM officials, they expect that the FSM's formula for distributing compact grants within the FSM will also apply to compact trust fund disbursements and no changes to the formula are being discussed. However, FSM representatives also noted that the FSM law establishing the distribution of the grants refers only to grants; therefore, the law would have to be amended to refer to trust fund disbursements.

[59]According to a representative of Graduate School USA, which has studied the compact trust fund in prior years, predictions of the fund balance before the end of the fiscal year are not reliable. The representative said that the compact trust funds' rates of return as of the end of July—that is, 2 months before the end of the fiscal year—are not a reliable predictor of their rate of return at the end of the fiscal year.

[60]According to the trust funds' administrator, there has never been a significant difference between the preliminary, unaudited compact trust fund balances at the end of the fiscal year and the final, audited balances.

cycles are completed before the annual amounts available for disbursement will be known. As a result, the FSM and RMI would have to budget without knowing the amount to be disbursed, complicating their annual budget and planning processes. See figures 7 and 8 for the FSM and RMI budget timelines for fiscal year 2024, based on their current budget calendars, relative to the dates when the compact trust fund disbursement amounts will be determined on the basis of the funds' unaudited end-of-fiscal-year balances and of their audited balances. *Standards for Internal Control in the Federal Government*—which is applicable to the U.S. government but can be adopted as a best practice by nongovernmental entities—states that management should use quality information to achieve the entity's objectives.[61] For example, as part of using quality information, the entity obtains relevant data from reliable internal and external sources in a timely manner based on the identified information requirements.

Figure 7: FSM National Government's Projected Budget Timeline Relative to Date When Compact Trust Fund Disbursement May Be Determined for Fiscal Year 2024



Source: GAO analysis of Federated States of Micronesia (FSM) government documents and U.S.-FSM compact trust fund agreement. | GAO-18-415

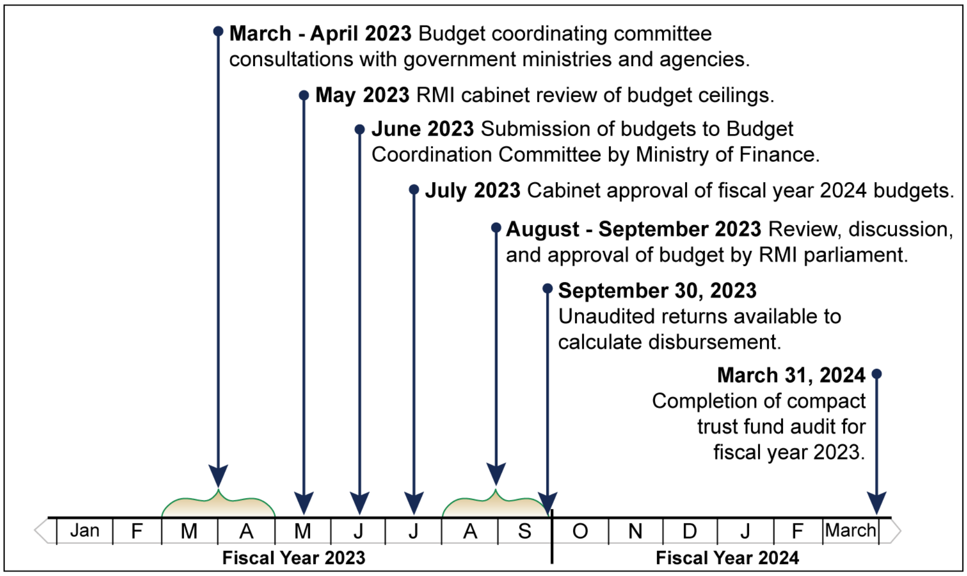
Notes: Dates shown for fiscal year 2024 are projected on the basis of selected dates in the FSM national government's budget calendar for fiscal year 2018. Not all steps in the calendar are shown.

The national government's budget timeline is shown for illustrative purposes. According to FSM national government officials, the budget timeline for each of the four FSM states differs from the

[61] GAO-14-704G.

national government's and the other states' timelines, and all of the states' timelines start and finish earlier than the national government's timeline.

Figure 8: RMI National Government's Projected Budget Timeline Relative to Date When Compact Trust Fund Disbursement May Be Determined for Fiscal Year 2024



Source: GAO analysis of Republic of the Marshall Islands (RMI) government documents and U.S.-RMI compact trust fund agreement. | GAO-18-415

Note: Dates shown for fiscal year 2024 are projected on the basis of selected dates in the RMI government's current budget calendar. Not all steps in the calendar are shown.

Given the FSM's and RMI's current budget processes, the FSM and RMI will not have accurate and timely information on the amounts that will be available for annual disbursements for each fiscal year. The FSM Secretary of Finance and Administration, a member of the compact trust fund committee, indicated that she is aware of the discrepancy between the timing of the trust fund disbursement calculations and dates in the FSM's budget and planning cycle and stated that the FSM would raise the issue of this discrepancy as part of its planning for the transition to relying on compact trust fund disbursements. One of the RMI's representatives on the compact trust fund committee stated that the timing of the disbursement calculations was a challenge and would complicate RMI planning and management. Each trust fund committee received a briefing in 2016 from the trust funds' administrator that discussed issues associated with the timing of the disbursement calculations. However, as of January 2018, the committees had not determined how they would address this issue.

FSM and RMI Decrement Plans Were Not Implemented Because of Increased Revenues, but Each Country Has Begun New Planning Efforts

The FSM and RMI did not implement planned budget reductions to address decreasing compact sector grants because of increasing revenue from other sources. FSM officials stated that they did not implement their plan's planned budgetary reductions due to increasing revenues for the state and national governments. The RMI also did not implement budget reductions but used increased revenue, particularly from fishing fees, to offset the decrement in compact sector grants. FSM and RMI strategic plans in the key sectors of education and health focus on strategic goals and priorities rather than addressing the effect of the 2023 transition on health and education budgets. However, FSM and RMI infrastructure plans discuss funding requirements and potential alternative funding sources. The FSM, the RMI, and the United States have each established bodies to plan to address issues related to the 2023 transition to trust fund income.

Previous Decrement Management Plans Were Not Implemented Because of Growth in Revenues

FSM Long-Term Fiscal Framework

The FSM has not implemented budget reductions scheduled in its decrement management plan, the *FSM-Wide Long-Term Fiscal Framework* (Long-Term Fiscal Framework).[62] The FSM's plan included a firm commitment for a 6 percent reduction in real terms in FSM state expenditures in fiscal year 2014. Two additional 6 percent expenditure reductions were planned for fiscal years 2017 and 2020, but these were contingent reductions that would not be implemented if the FSM states received offsetting revenue to address the reductions. According to FSM national government officials, revenue increases, including growth in revenue from fishing fees, have enabled the FSM to avoid implementing the 2017 contingent 6 percent expenditure reductions, and the further reductions in fiscal year 2020 are not likely to be implemented. FSM officials cited multiple reasons for not implementing the planned reductions:

- **Increasing revenue to the state and national governments.** The FSM's Long-Term Fiscal Framework included a plan to increase the

[62]Federated States of Micronesia, *FSM-Wide Long-Term Fiscal Framework, FY 2014-FY 2023.*

proportion of compact sector grant funding distributed among the FSM states and reduce the proportion retained by the national government. This change in the FSM's internal compact grant distribution formula reduced the amount of the decrement in compact sector grants received by the states that would have otherwise occurred. The FSM national government's revenue from fishing fees has increased rapidly in recent years, allowing it to use this revenue in place of compact sector grants.[63]

- **Effect of inflation adjustments on compact sector grants.** According to FSM officials, because of inflation adjustments, the nominal value of the compact sector grants has not significantly declined. As a result, the FSM government questions the need for expenditure reductions.[64]

In addition to scheduling budget reductions, the FSM's Long-Term Fiscal Framework included plans to implement unified tax reform measures, which also have not been implemented. However, plans to reduce the national government's share of compact sector grants and to use surpluses to mitigate the effect of fiscal reforms were implemented. (See app. VIII for a summary of the FSM's planned actions and their implementation.) As of January 2018, the FSM had not updated the Long-Term Fiscal Framework but had included information updates in its annual budget submittal.

RMI Decrement Management Plan

The RMI government has not implemented budget reductions scheduled in its decrement management plan.[65] The RMI's decrement management plan divided proposed budgetary reductions into three periods: fiscal years 2016 through 2017, fiscal years 2018 through 2020, and fiscal years 2021 through 2023. Only the reductions in the first period were to be considered binding, with adjustments in the later periods subject to

[63]The FSM national government receives and controls fishing fee revenue. The government's revenue from Parties to the Nauru Agreement fishing fees increased from $17.7 million in fiscal year 2010 to $63.4 million in fiscal year 2016. The FSM national government had a budget surplus in fiscal years 2012 through 2016 as a result of the increased fees. In fiscal year 2016 the FSM overall had a surplus of approximately $24 million (7 percent of GDP). The national government had a fiscal surplus of $26.6 million, while all four states had deficits that together totaled approximately $2.5 million.

[64]While the nominal value of compact sector grants has not declined in recent years, the partial inflation adjustment and declining amount of the base grant result in a decline in resources in real terms.

[65]Republic of the Marshall Islands, *Decrement Management Plan, FY 2015-FY 2023* (Sept. 3, 2014).

review during the next 3-year planning cycle. According to RMI government officials, significant growth in fishing fee revenue and growth in ship registry and income tax revenue has minimized the initially anticipated impact of the compact decrements, thereby reducing the need to implement expenditure reductions.[66] RMI officials noted that it expected to continue to use its own revenue in place of compact funds in fiscal years 2019 through 2023.

In addition to scheduling the budget reductions, the RMI decrement management plan includes plans to implement new taxes, program fishing fees into the annual budget, reduce subsidies to state-owned enterprises, and reduce compensation to Majuro landowners for the use of their land for utilities. The RMI has programmed a portion of its fishing fee surplus into the annual budget in each fiscal year from 2015 to 2017 but has not implemented other planned actions. (See app. VIII for a summary of planned actions and their implementation.) As of January 2018, the RMI government had not updated its plan and did not intend to do so, according to RMI officials. However, the officials stated that the government has incorporated elements of the plan, particularly its expenditure analysis, into the RMI's medium term budget and investment framework, a planning and budgeting document submitted to JEMFAC in August 2017. In comments on a draft of this report, the RMI stated that it is developing a long-term fiscal framework in addition to the medium term budget and investment framework. According to the RMI, the long-term fiscal framework will have a 10-year outlook through 2028 and take into account compact decrements and anticipated resources from the compact trust fund and other sources.

FSM and RMI Have Developed Plans for Health, Education, and Infrastructure

FSM Sector Plans

FSM national and state infrastructure plans provide specific budgetary information to address the fiscal year 2023 transition from compact sector

[66]Fishing fees received as a result of the Parties to the Nauru Agreement have increased rapidly in recent years, from $2.0 million in fiscal year 2010 to $26.3 million in fiscal year 2016. The RMI had a fiscal surplus in each fiscal year from 2014 to 2016, with the 2016 surplus rising to approximately $8 million (4 percent of GDP).

grants to trust fund income, such as funding requirements and sources of funding for planned infrastructure projects in fiscal years 2016 through 2025. The FSM national and state health and education plans generally focus on the national and state health and education departments' strategic goals and priorities rather than discussing budget changes or new revenue generation strategies to address the possibility of reduced resources after 2023.[67]

In addition to preparing sector strategic development plans, the FSM national and state governments issued the *2023 Action Plan* in 2014, designed to address fiscal and economic challenges before and after compact sector grant funding ends in fiscal year 2023.[68] In contrast to the FSM Long-Term Fiscal Framework, which committed to specific expenditure reductions and government actions prior to fiscal year 2023, the 2023 *Action Plan* includes an economic growth strategy that seeks to boost private sector development. The plan addresses economic growth strategies and improved performance in key economic sectors such as tourism, agriculture, and fisheries and identifies the need for the FSM national and state governments to limit expenditure growth in the medium and long terms.

RMI Sector Plans

The RMI's infrastructure plan addresses the scheduled cessation of compact sector grant assistance in fiscal year 2023 through a review of potential future budgets, while the RMI's education and health plans outline strategic goals and priorities. Similar to the FSM's infrastructure plans, the RMI National Infrastructure Plan reviews budget information to address the fiscal year 2023 transition, such as planned infrastructure investments and potential alternative funding sources for fiscal years 2017 through 2026.[69] The RMI's national education and health plans primarily focus on goals and objectives to address key challenge areas in health and education over the next few fiscal years and do not discuss specific budget changes for the transition in 2023.

[67]A plan for Yap's education sector is not available.

[68]Government of the Federated States of Micronesia, 2023 Planning Committee, *2023 Action Plan* (Palikir, Pohnpei: November 2014).

[69]In comments on a draft of this report, the RMI stated that it is also developing a comprehensive infrastructure development and maintenance plan that will integrate compact and noncompact infrastructure resources, programs, and projects over a 10-year span up to 2028.

FSM, RMI, and U.S. Planning Groups Have Been Formed to Prepare for Transition to Trust Fund Income

Both the FSM and the RMI have formed planning committees and charged them with planning for the fiscal year 2023 transition from compact sector grants to compact trust fund income. In addition, the U.S. Department of State (State) has organized a U.S. interagency planning group to help coordinate U.S. policy related to the transition.

FSM Joint Compact Review and Planning Committee

In 2016, the FSM national government established a Joint Compact Review and Planning Committee to coordinate FSM planning for the transition from compact sector grants to trust fund income in 2023. The committee is mandated to, among other things, set goals in anticipation of the end of compact grants, develop strategies and alternatives, identify financial assistance sources, analyze economic information, and provide periodic reports to the FSM Congress. The committee first met in May 2017. In September 2017, the committee hired an Executive Director, who in turn hired an economist and Executive Secretary prior to the committee's February 2018 meeting. As of January 2018, according to FSM officials, the committee had not produced any publicly available products but had collected information from various FSM government agencies.

RMI Compact Review Commission

According to the RMI Office of Compact Implementation, the RMI established the Compact Review Commission in late 2016 to plan for the fiscal year 2023 transition from compact sector grants to trust fund income. According to the Office of Compact Implementation, the commission is mandated to review the compact and make recommendations to the cabinet regarding priorities to be addressed for the fiscal year 2023 transition. Specific priorities may include the status of federal programs that will expire in fiscal year 2023, the adequacy of the compact trust fund to provide needed revenue, and other issues relevant to the cessation of compact grant assistance. In January 2018, the RMI Presidential Cabinet appointed a Compact Review Commission Coordinating Committee, consisting of the RMI Ambassador to the United States, the Director of the RMI Office of Compact Implementation, the Secretary of Finance, a private sector representative, and a legal adviser, and directed it to coordinate the commission's meetings, actions, and reporting.

Ongoing U.S. Interagency Working Group

State began holding regular meetings of the Interagency Working Group on the Freely Associated States in February 2017 to provide guidance and oversight for policy concerning the Compacts of Free Association and to coordinate U.S. policy in light of the fiscal year 2023 transition. The group met monthly through the rest of 2017, except in November. The monthly meetings have focused individually on the FSM and RMI, as well as addressed cross-cutting issues such as donor coordination.[70] For example, in March and July 2017, the group's monthly meetings focused on the FSM and included participation by the U.S. Ambassador and the FSM Ambassador, respectively. Similarly, in April and June 2017, the group's monthly meetings focused on the RMI and included participation by the U.S. and RMI ambassadors, respectively. According to State officials, the meetings will continue indefinitely on a monthly basis.[71]

Conclusions

The U.S. compacts of free association with the FSM and the RMI provided a framework for the United States and the two countries to work toward, among other things, the goal of assisting the FSM and the RMI in their efforts to achieve economic development and self-sufficiency. The end of U.S. compact sector grants in fiscal year 2023 and the beginning of disbursements from the compact trust funds in fiscal year 2024 will mark a key transition in these ongoing efforts, and the FSM and RMI are currently preparing plans for addressing issues associated with the transition to compact trust fund income. The countries' transition to relying on income from the compact trust funds will likely require significant budgetary choices. However, lacking the trust fund distribution policies required under the trust fund agreements, the FSM and RMI are hampered in their efforts to plan for the potential reduction in U.S. compact assistance after 2023. In addition, without the required fiscal procedures governing trust fund actions after 2023, the trust fund committees will be unable to make disbursements and the United States, the FSM, and the RMI will not have assurance of necessary oversight of trust fund disbursements. Finally, without alignment between the timing of the trust fund committees' annual calculation of the amounts available for disbursement and the countries' annual budget cycles, the FSM and RMI

[70]The Interagency Working Group has held meetings focused on Palau in addition to those focusing on the FSM and RMI.

[71]U.S. participants in the group have included representatives from the U.S. Departments of Agriculture, Commerce, Defense, Education, Energy, Homeland Security, Health and Human Services, Housing and Urban Development, the Interior, State, Transportation, the Treasury, and Veterans Affairs; the Environmental Protection Agency; the Federal Deposit Insurance Corporation; the National Science Foundation; the Office of Management and Budget; the Peace Corps; USAID; the U.S. Postal Service; and the U.S. Trade Representative.

will have to plan their budgets for each fiscal year without knowing the amount of the disbursements from the compact trust funds.

Recommendations for Executive Action

We are making the following six recommendations to Interior:

The Secretary of the Interior should ensure that the Director of the Office of Insular Affairs, as Chairman of the FSM compact trust fund committee, works with other members of the committee to develop a distribution policy for the FSM compact trust fund, as required by the compact trust fund agreement, that takes into account potential strategies that could address risks to the fund's ability to provide a source of income after fiscal year 2023. (Recommendation 1)

The Secretary of the Interior should ensure that the Director of the Office of Insular Affairs, as Chairman of the FSM compact trust fund committee and of the FSM Joint Economic Management Committee, works with other members of the committees to develop the fiscal procedures required by the compact trust fund agreement. (Recommendation 2)

The Secretary of the Interior should ensure that the Director of the Office of Insular Affairs, as Chairman of the FSM compact trust fund committee, works with other members of the committee to address the timing of the calculation of compact trust fund disbursements. (Recommendation 3)

The Secretary of the Interior should ensure that the Director of the Office of Insular Affairs, as Chairman of the RMI compact trust fund committee, works with other members of the committee to develop a distribution policy for the RMI compact trust fund, as required by the compact trust fund agreement, that takes into account potential strategies that could address risks to the fund's ability to provide a source of income after fiscal year 2023. (Recommendation 4)

The Secretary of the Interior should ensure that the Director of the Office of Insular Affairs, as Chairman of the RMI compact trust fund committee and of the RMI Joint Economic Management and Financial Accountability Committee, works with other members of the committees to develop the fiscal procedures required by the compact trust fund agreement. (Recommendation 5)

The Secretary of the Interior should ensure that the Director of the Office of Insular Affairs, as Chairman of the RMI compact trust fund committee, works with other members of the committee to address the timing of the calculation of compact trust fund disbursements. (Recommendation 6)

Agency Comments and Our Evaluation

We provided a draft of this report to the Departments of Agriculture, Commerce, Defense, Education, Energy, Health and Human Services, the Interior, Labor, State, the Treasury, and Transportation; the Federal Communications Commission; the Federal Deposit Insurance Corporation; the Federal Emergency Management Agency; the National Science Foundation; USAID; and the U.S. Postal Service, as well as to the FSM and RMI. We also provided copies of the draft to the administrator of each compact trust fund and to Graduate School USA for their technical review. The Department of the Interior, the U.S. Postal Service, and the FSM and RMI provided official comments, which are reproduced in appendixes IX through XII with, where relevant, our responses. The Departments of Agriculture, Education, Health and Human Services, Labor, State, and Transportation; the Federal Deposit Insurance Corporation; USAID; the RMI; the trust funds' administrator, and Graduate School USA provided technical comments, which we incorporated as appropriate.

The following summarizes the official comments from Interior, the U.S. Postal Service, the FSM, and the RMI, and our responses.

- Interior concurred with our recommendations and stated that discussions to address them are ongoing within the trust fund committees. In addition, Interior stated that a working group comprising staff from Interior's Office of Insular Affairs and the Department of State's Office of Australia, New Zealand and Pacific Island Affairs will present recommended actions related to our recommendations to the trust fund committees in 2018.
- The U.S. Postal Service stated that, in general, the report includes helpful information on the compact obligations regarding postal services provided to the FSM and RMI. However, the U.S. Postal Service also provided additional information on the reimbursement shortfall for its services since 2002 in the freely associated states. The U.S. Postal Service stated that it recommends that, upon expiration of the programs and services agreements, the FSM and RMI be treated as international postal origin and destination points.
- The FSM concurred with our recommendations to Interior. In addition, the FSM stated that the programs and services provided by U.S. agencies were essential to the FSM and should continue to the

greatest extent possible after 2023. The FSM would like to work with U.S. officials to ensure timely approval of continuing these programs and services. The FSM also noted that we had reported the potential for the FSM compact trust fund to not provide disbursements sufficient to cover the estimated value of expiring federal services in 2002, prior to the signing of the amended compact.[72] Further, the FSM provided additional information regarding its Long-Term Fiscal Framework and summarized ongoing public sector and tax reform efforts and its own contributions to the FSM Trust Fund.

- The RMI concurred with our recommendations to Interior and provided additional comments regarding the recommendations. The RMI asserted that, absent accountability issues, the maximum annual disbursement amount should be disbursed from the compact trust fund. However, as our report notes, the compact trust fund agreements state the maximum allowable disbursement level and do not establish or guarantee a minimum disbursement level. The RMI also stated that it would prefer that future accountability procedures be based on a new agreement rather than a reshaping of the current fiscal procedures agreement. In addition, the RMI raised the issue of compensation under the tax and trade provision of the original compact as well as the effect of delays in investing the RMI compact trust fund on its current value. We discuss the tax and trade provisions in Appendix VII of our report. The RMI also recommended that amendments to the trust fund agreement should not require action by the U.S. Congress. As our report notes, the U.S. legislation implementing the amended compacts requires that any amendment, change, or termination of all or any part of the compact trust fund agreements shall not enter into force until incorporated into an act of Congress. Finally, the RMI noted that programs and services provided through the amended compacts' implementing legislation (Pub. L. No. 108-188) and the compact programs and services agreement were essential and that the RMI could not replace them by using its own resources.

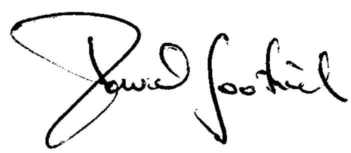
We are sending copies of this report to the appropriate congressional committees and to the Departments of Agriculture, Commerce, Defense, Education, Energy, Health and Human Services, the Interior, Labor, State, the Treasury, and Transportation; the Federal Communications

[72]See GAO, *Compacts of Free Association: An Assessment of Current U.S. Proposals to Extend Assistance*, GAO-02-857T (Washington, D.C.: July 17, 2002).

Commission; the Federal Deposit Insurance Corporation; the Federal Emergency Management Agency; the National Science Foundation; USAID; and the U.S. Postal Service, as well as the President of the FSM and the President of the RMI. In addition, the report will be available at no charge on GAO’s website at http://www.gao.gov.

If you or your staff have questions about this report, please contact me at (202) 512-3149 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 XIII.

Sincerely yours,



David Gootnick
Director, International Affairs and Trade

Appendix I: Objectives, Scope, and Methodology

We were asked to review issues related to the Federated States of Micronesia's (FSM) and Republic of the Marshall Islands (RMI) transition from compact grant assistance to relying on income from the compact trust funds. This report examines (1) the use and role of federal funds and programs in the FSM and RMI budgets, (2) projected compact trust fund disbursements and potential strategies to address risks to those disbursements, and (3) FSM and RMI efforts to prepare for the scheduled decrements in compact grant funding and the transition to relying on compact trust fund income.

Federal Funds and Programs

To identify the use and role of federal funds and programs, we reviewed relevant documents and interviewed knowledgeable U.S., FSM, and RMI officials during our site visits to the RMI in July 2017 and in the FSM in July and August 2017. We reviewed U.S. law; the amended compacts and associated programs and services agreements and military use and operating rights agreements with each country; each country's government and component unit single audit reports for fiscal years 2012 through 2016; and U.S. Region IX reports for fiscal years 2015 and 2016.[1] We analyzed expenditure and funding data in FSM and RMI single audit reports, including their Schedule of Expenditures of Federal Awards, to identify the sources of funds expended by the FSM national and state governments, the RMI national government, and their component units and calculated federal funds as a percentage of each entity's total resources.[2] We reviewed the single audit reports and found that the auditors did not express any qualified or adverse opinions regarding the information they used to prepare the audits' Schedule of Expenditures of Federal Awards, which lists the amount and use of federal grants. We concluded that these data are sufficiently reliable for estimating the role of federal programs in the FSM and RMI budgets.

[1]Region IX Federal Regional Council, Outer Pacific Committee, *FY 2016 Report on Federal Financial Assistance to the U.S. Pacific and Caribbean Islands* (May 1, 2017); and *FY 2015 Report on U.S. Federal Financial Assistance to the U.S. Affiliated Pacific Islands* (March 2016).

[2]The threshold for requiring single audit reports is expenditure of $750,000 or more in federal funds in any given year. All FSM states and the FSM and RMI national governments expended above the threshold amount in each year of our analysis. If a component unit expended an amount below the threshold, we may not have captured those federal funds in our analysis.

To identify the FSM and RMI national government component units and FSM state government component units, we reviewed the websites of, and audit reports from, the FSM Office of the National Public Auditor and the RMI Office of the Auditor-General and confirmed the list of component units we identified with FSM and RMI officials. We also discussed the uses of federal funds in the countries with FSM national and state government officials, RMI government officials, and FSM and RMI component unit representatives during our site visits to the countries. Our portrayal of the role of federal funds in the government and component unit budgets does not capture the value of any noncash goods and services that do not appear in the single audit reports. In addition, it does not capture benefits that some programs provide to individuals, such as U.S. Department of Agriculture rural housing loans and Federal Deposit Insurance Corporation insurance that benefits depositors at the Bank of the Federated States of Micronesia.

To determine the legal status of U.S. programs, services, and grants after fiscal year 2023, we analyzed the amended compacts, the compact-related agreements, and U.S. law governing the programs, services, and grants that we identified to determine whether, under current law, they would still be available to the FSM and RMI after the end of that fiscal year. For the programs and services agreement with each country, we reviewed the status of programs and services when the agreements end in fiscal year 2024. Our legal analysis included programs, services, and grants that we identified from the compacts, the amended compacts' implementing legislation, the military use and operating rights agreements, and the programs and services agreements. We also included in our legal analysis the programs (1) that we identified through the single audit reports and Region IX reports and (2) that were not already identified through our review of the compacts, the amended compacts' implementing legislation, and the compact-related agreements; and (3) that the single audit reports showed as having expenditures above $200,000 in any year in fiscal years 2012 through 2016 or the Region IX reports identified as providing more than $200,000 in federal funding in fiscal years 2015 or 2016. We prepared an initial list of federal programs based on our review. We then provided our list of programs to the FSM, the RMI, and the U.S. Departments of State and the Interior for their review and updated the list on the basis of information they provided.

We prepared a preliminary analysis of the post-2023 status of the programs and funding sources we identified and asked officials of the relevant U.S. agencies to review and comment on the accuracy of the list. As part of this analysis, we contacted officials from the Departments of

Agriculture, Commerce, Defense, Education, Energy, Health and Human Services, the Interior, Labor, State, and Transportation; the Federal Communications Commission; the Federal Deposit Insurance Corporation; the Federal Emergency Management Agency; the National Science Foundation; the U.S. Agency for International Development; and the U.S. Postal Service. We incorporated into our analysis the comments that these officials provided, and we again asked for their review of our analysis before we completed our draft report. Our conclusions are based on a review of current law. Therefore, any changes in the applicable law subsequent to our report but before 2023 may affect the FSM's and RMI's eligibility for U.S. programs and funding. In addition, the availability of programs depends on appropriations made for that purpose. Although we took multiple steps to validate our list of programs with the FSM and RMI and the relevant U.S. agencies, our analysis may not have captured all U.S. grants and programs provided in the FSM and RMI.

Compact Trust Funds

To examine projected compact trust fund disbursements and actions to address risks, we reviewed previous studies of the compact trust funds;[3] the U.S.-FSM and U.S.-RMI compact trust fund agreements; and other governance and reporting documents such as investment policy statements, presentations to the compact trust fund committees, audits, and annual reports. We also interviewed FSM and RMI officials, compact trust fund committee members, authors of the previous studies, and the funds' administrator, investment advisers and money managers.

[3]We reviewed the following previous studies: GAO, *Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income*, GAO-07-513 (Washington, D.C.: June 15, 2007); Graduate School USA, *Compact Trust Funds in the Freely Associated States: Mechanics and Stochastic Projections* (Honolulu, Hawaii: April 2018); Graduate School USA, *FSM FY2016 Economic Brief* (Honolulu, Hawaii: August 2017); Graduate School USA, *RMI FY2016 Economic Brief* (Honolulu, Hawaii: August 2017); Graduate School USA, *Federated States of Micronesia Fiscal Year 2015 Economic Review* (Honolulu, Hawaii: October 2016); Graduate School USA, *Republic of the Marshall Islands Fiscal Year 2015 Economic Review* (Honolulu, Hawaii: October 2016); Graduate School USA, *Federated States of Micronesia Fiscal Year 2014 Economic Review* (Honolulu, Hawaii: September 2015); Graduate School USA, *Republic of the Marshall Islands Fiscal Year 2014 Economic Review* (Honolulu, Hawaii: September 2015); Asian Development Bank, *Trust Funds and Fiscal Risks in the North Pacific: Analysis of Trust Fund Rules and Sustainability in the Marshall Islands and the Federated States of Micronesia* (Manila, Philippines: 2015); International Monetary Fund, *Federated States of Micronesia: Staff Report for the 2017 Article IV Consultation* (Washington, D.C.: Aug. 4, 2017); and International Monetary Fund, *Republic of the Marshall Islands: Staff Report for the 2016 Article IV Consultation* (Washington, D.C.: Jul. 7, 2016).

To project the compact trust funds' likely income at their current value and under current trust fund rules (i.e., the baseline scenario), we built a Monte Carlo simulation model and performed 10,000 trial runs of projected returns and disbursements over a four-decade time period, using random values for key variables.[4]

We used the following key assumptions in our compact trust fund analysis:

- **Compact trust fund balance.** We used the unaudited FSM and RMI fiscal year 2017 year-end compact trust fund balances.
- **C account balance.** We estimated the C account balance on the basis of the unaudited FSM and RMI fiscal year 2017 year-end balances.

To assess the reliability of the unaudited balances, we reviewed the previous years' audits and confirmed with the trust funds' Administrator that previous years' audits had not resulted in any significant differences between the preliminary balances and the final audited balances. We concluded that the unaudited balances were sufficiently reliable as a basis for our projections of future trust fund performance. The March 2018 audited fund balances, released after we completed our analysis, were within $5 of the unaudited fund balances.

- **Amount of future compact trust fund contributions.** We based the amounts of future annual U.S. contributions to both trust funds on the inflation-adjusted amounts estimated in the U.S. Department of the Interior's (Interior) Office of Insular Affairs' *Budget Justifications and Performance Information, Fiscal Year 2018.* For the RMI, we assumed that Taiwan would continue to contribute $2.4 million per year to the RMI's A account each year through 2023 in keeping with Taiwan's May 2005 agreement with the RMI.
- **Estimated annual grant assistance for fiscal year 2023.** We based our estimates of fiscal year 2023 assistance on the inflation-adjusted amounts estimated by the Office of Insular Affairs.[5] The office

[4]A Monte Carlo analysis is a problem-solving technique that approximates the probability of certain outcomes by performing multiple trial runs, or simulations, using random variables. The simulations capture the volatility of market returns and reflect that volatility in the projection of future earnings.

[5]Department of the Interior, Office of Insular Affairs, *Budget Justifications and Performance Information, Fiscal Year 2018*.

estimated that the FSM would receive $82 million in annual grant assistance in fiscal year 2023 and that the RMI would receive $36 million, including Kwajalein-related assistance. In keeping with the RMI compact trust fund agreement, we excluded from our analysis grants provided to the RMI under compact section 211(b) for Kwajalein-related assistance, resulting in an estimated $27 million in grant assistance to the RMI under compact section 211 in fiscal year 2023. The actual amount of annual grant assistance in fiscal year 2023 will depend on actual inflation rates in the years preceding 2023. Different assumptions about the inflation rates will result in different estimates of the amount of fiscal year 2023 annual grant assistance.[6]

- **Net rate of return.** In the baseline scenario, we present our results based on a 6 percent rate of return after fees are deducted. To select and assess the reasonability of this projected net rate of return, we reviewed the capital market assumptions and projections used by the money managers for the compact trust funds as well as historical market rates of return. However, because projecting the funds' long-term performance using the current portfolio and economic assumptions has limitations, we also conducted our analyses using different nominal values for the net returns—5 percent, 7 percent, and 8 percent—in each case using a standard deviation of 13 percent.[7] These results are presented in appendix V. We assumed a normal distribution, but we tested the same baseline analyses with a t-distribution and found that a t-distribution did not substantially affect the results.

[6]The Department of the Interior, Office of Insular Affairs, *Budget Justifications and Performance Information, Fiscal Year 2019* includes a reduced estimate of future inflation, resulting in estimated fiscal year 2023 annual grant assistance of $81.6 million in the FSM and $26.7 million in the RMI. The fiscal year 2017 compact trust fund financial statements estimated that fiscal year 2023 grant assistance will be $79.7 million in the FSM and $26.1 million in the RMI. In August 2017, Graduate School USA's *FSM FY2016 Economic Brief* and *RMI FY2016 Economic Brief* estimated fiscal year 2023 annual grant assistance to be $81 million in the FSM and $26.5 million in the RMI.

[7]This standard deviation is an average of the standard deviations for the FSM and RMI compact trust funds expected by the compact trust fund money managers. Although we believe using a standard deviation based on those in the fund managers' capital market assumptions is reasonable, using a single standard deviation based on the current portfolio and economic assumptions has limitations when projecting the long-term performance of the funds. Trade-offs between risk and return may affect the expected standard deviation for varying rates of return. However, finance research papers we reviewed that examined data on previous market returns did not find a consistent pattern for the direction of the change, finding both positive and negative relationships between risk and return.

- **Inflation rate after fiscal year 2023.** We applied the 2 percent long-term inflation rate projected by the Congressional Budget Office.

To further analyze actions that could address risks to the compact trust funds, we modeled alternative strategies for managing the funds that were analyzed by previous studies of the compact trust funds. We identified previous studies through a literature search and by interviewing cognizant agency and trust fund officials. On the basis of this review, we developed five potential strategies that are representative of the approaches identified in previous studies. These five strategies are examples of many possible strategies, including varying amounts of disbursement reductions, additional contributions, and methods of calculating annual disbursements. We are not recommending any specific strategy. To provide additional information about potential outcomes, we also analyzed another four strategies that assumed a lower amount of additional trust fund contributions, lower disbursement reductions, or a lower percentage of the compact trust fund balance that could be withdrawn (see app. VII). To help ensure that we had appropriately reproduced the methods used in previous studies, we shared our preliminary results for strategy 4, which modeled the Moving Adjustment Rule, and strategy 5, which modeled the Sustainability Adjustment for Enhanced Reliability (SAFER), with the Graduate School USA representatives who had initially prepared these potential strategies.[8] We analyzed each strategy separately to isolate the impact of individual changes in the strategy on compact trust fund balance and disbursements. However, in practice, these individual changes could occur in combination with each other. We again performed the Monte Carlo analysis, using the same key assumptions as in the baseline scenario, to determine the likely effects, relative to the baseline, of five potential strategies representing three approaches: (1) reducing annual compact trust fund disbursements; (2) making additional contributions; (3) and changing the disbursement policies, including strategies that would require changing the trust fund agreements to permit disbursements from the A account. We present the results of this analysis with a 6 percent net return, a standard deviation of 13 percent, and a normal distribution and

[8]We based strategies 4 and 5 on the technical description of MAR and SAFER in Graduate School USA's fiscal year 2014 trust fund report. Graduate School USA has continued to revise its model and, in April 2018, issued an updated review that uses 3-year moving averages instead of 5-year moving averages. See Graduate School USA, *Compact Trust Funds in the Freely Associated States: Mechanics and Stochastic Projections* (Honolulu, Hawaii: April 2018).

tested the results with 5 percent, 7 percent, and 8 percent net returns (see app. VII for further details).

To summarize and compare our simulation results for the baseline and alternate scenarios, we analyzed the average disbursements in nominal dollars, the average disbursements in comparison with maximum disbursements,[9] the likelihood of 1 or more years with zero disbursement, and the likelihood that the trust funds will maintain their inflation-adjusted value after fiscal year 2023.

- We calculated the average disbursement in the given time periods by averaging simulated disbursements over 10-year periods (averaging first over 10 years and then over 10,000 simulated cases).
- We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging the ratio of each simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given period (averaging first over 10 years and then over 10,000 simulated cases).
- We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement among the 10,000 simulated cases in each 10-year period.
- We calculated the likelihood that the fund balance will maintain its inflation-adjusted fiscal year 2023 value by counting simulation cases where the simulated balance exceeds or equals its projected inflation-adjusted 2023 balance in the given year.

We report the disbursement results averaged by decade for the first 40 years of compact trust fund disbursements—fiscal years 2024 through 2033, fiscal years 2034 through 2043, fiscal years 2044 through 2053, and fiscal years 2054 through 2063—to summarize the overall trend in disbursements. However, depending on market volatility, disbursements during these decades are likely to fluctuate from year to year. While the projected per-decade averages can show long-term trends in the funds' disbursements and sustainability and provide a comparison of the likely

[9]In addition the trust fund committees may approve additional amounts for special needs. Special needs are defined as projects that the government of the FSM or RMI deems necessary as a supplement to that portion of an annual budget to be financed by the compact trust funds, so long as the projects are for the purposes of Section 211 of the compact, as amended. We did not include the amount of funds approved for disbursements as special needs in the estimated disbursement in our analysis due to the uncertainty in the amount of special needs each year.

effects of the potential strategies we analyzed, the projected averages do not provide information about the volatility of changes in annual disbursement. We compare the compact trust funds' projected value with the projected inflation-adjusted fiscal year 2023 value through 2063 in 10-year increments beginning in fiscal years 2033.

To document the status of the FSM Trust Fund and the RMI's D account and their potential use to supplement FSM and RMI resources after 2023, we reviewed information about the FSM laws establishing the FSM Trust Fund, FSM economic reports, and the RMI-Taiwan agreement regarding the D account. We also interviewed FSM and RMI officials. We did not independently verify the FSM's projections of the future size of, and disbursements from, its trust fund. The information on foreign law or on foreign government operations in this report is not the product of our original analysis, but is derived from interviews and secondary sources.

FSM and RMI Plans

To examine FSM and RMI efforts to prepare for the scheduled compact grant decrements, we reviewed each country's decrement management plans to determine the FSM's and RMI's planned budget reductions and other actions. We then reviewed the FSM's and RMI's single audit reports and budget documents and interviewed FSM and RMI officials to determine whether the planned reductions had been implemented. We compared the planned actions to current legislation, single audit reports, or recent reports that discussed the status of FSM and RMI economic and financial reforms. In addition, we interviewed Interior, FSM, and RMI officials to determine whether FSM and RMI decrement management plans had been revisited or updated, why the plans were or were not adhered to, and whether the countries planned any future updates to the plans. We also conducted interviews with U.S. officials from the Department of State, a representative of Graduate School USA, and representatives of the World Bank and the International Monetary Fund regarding each country's previous and current planning efforts.

To assess whether the FSM and RMI strategic plans for the key sectors of health, education, and infrastructure addressed the 2023 transition from compact grants and other U.S. assistance to compact trust fund income, we first obtained the relevant plans from department heads in each key sector of the FSM and RMI national governments and FSM state governments and confirmed our identification of the documents with FSM and RMI officials. We reviewed the plans to determine whether they included any discussion of budget projections, economic or financial reforms, alternative funding sources or other revenue generation strategies, and expenditure cuts or saving strategies for periods before and after fiscal year 2023. We also reviewed the FSM's *2023 Action Plan* and the RMI's updated Medium Term Budget and Investment Framework to determine whether these documents discussed budget changes to address the 2023 transition.

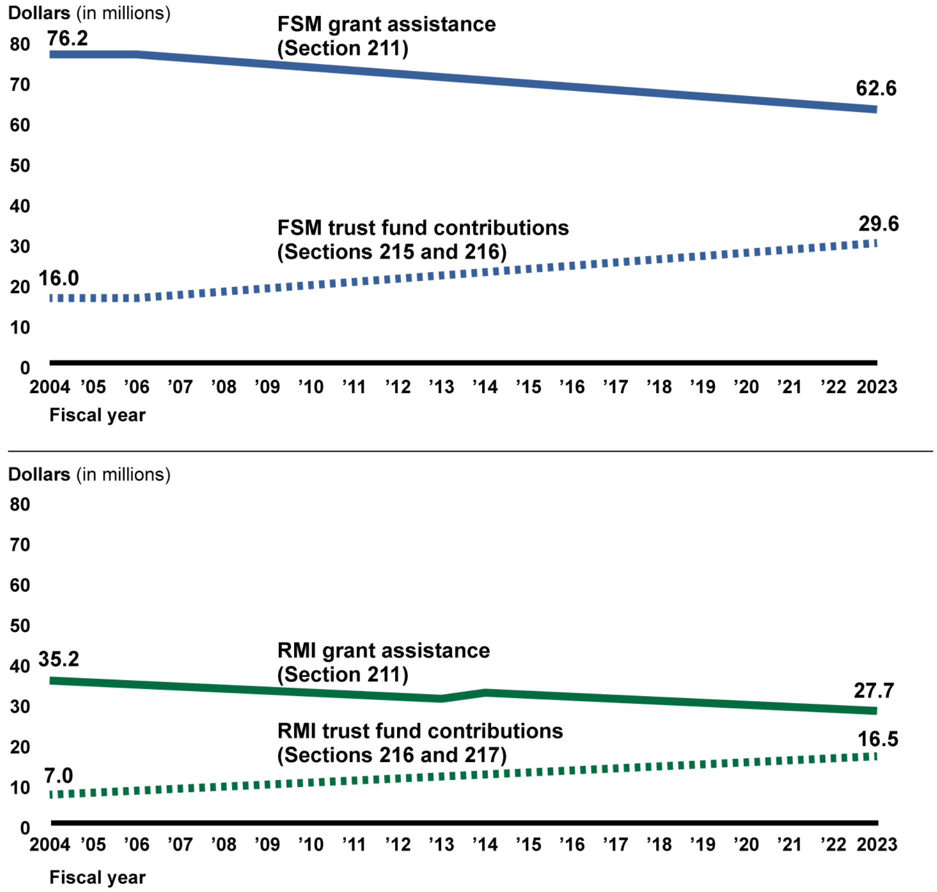
Through our interviews with U.S., FSM, and RMI officials, we also learned about other ongoing planning efforts to address the 2023 transition: the U.S. Interagency Working Group on the Freely Associated States, the FSM Joint Compact Review and Planning Committee, and the RMI Compact Review Commission. Following our interviews, we reviewed and summarized documentation related to the working group's purpose, meetings, and membership. We also contacted FSM and RMI committee members and officials to obtain additional information on the mandate, membership, and status of the FSM and RMI committees. The information contained in this report on foreign law or on foreign government operations is not the product of our original analysis, but is derived from interviews and secondary sources.

We conducted this performance audit from March 2017 to May 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: U.S. Compact Sector Grants and Trust Fund Contributions, 2004 through 2023

The amended compacts' implementing legislation authorized and appropriated direct financial assistance to the FSM and the RMI in fiscal years 2004 through 2023, and provided for partial inflation adjustment of the base amount of compact sector grants and trust fund contributions each year. The base amount is partially inflation-adjusted by the percentage that equals two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator, or 5 percent, whichever is less in any 1 year, using the beginning of 2004 as a base. As the base amount of compact sector grants decreases, the trust fund contributions generally increase by an equivalent amount. Figure 9 shows the amount of compact sector grants and trust fund contributions each fiscal year from 2004 through 2023.

Figure 9: U.S. Grants and Trust Fund Contributions to Be Provided to the FSM and RMI under the Amended Compacts, Prior to Partial Adjustments for Inflation, Fiscal Years 2004 through 2023

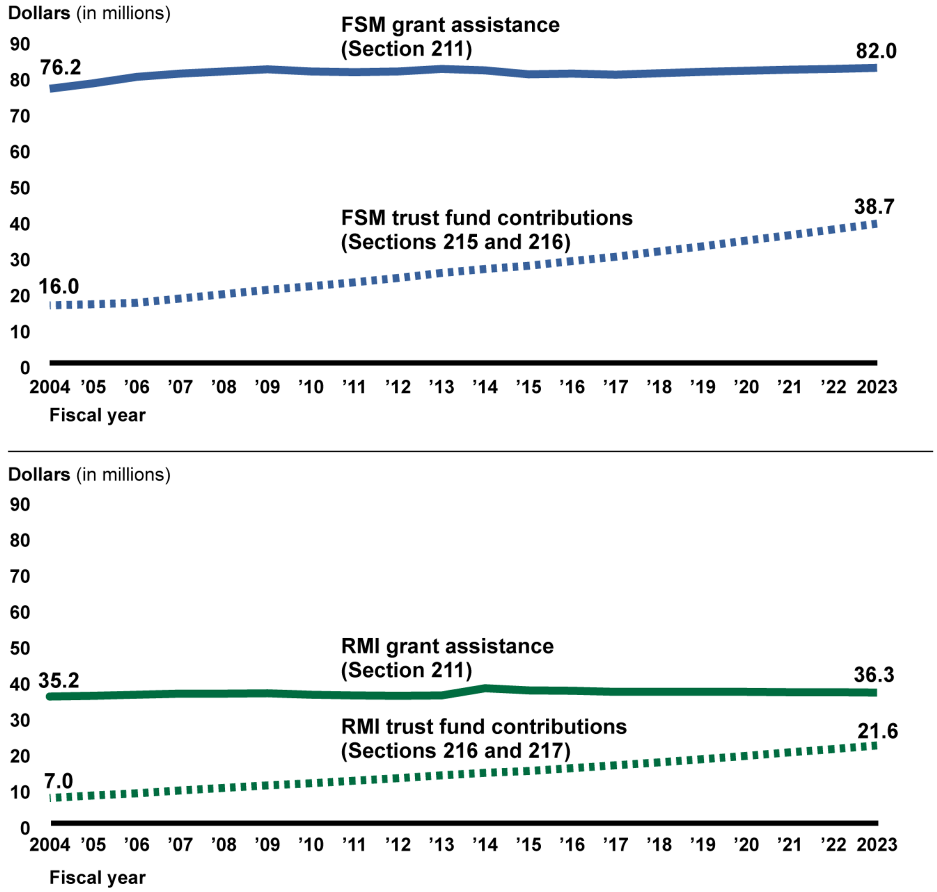


Source: Compacts of Free Association as Amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia (FSM) and the Government of the Republic of the Marshall Islands (RMI), Pub. L. No. 108-188. | GAO-18-415

Notes: Sections 211 and 216 of the FSM amended compact and sections 211 and 217 of the RMI amended compact detail grants to the FSM and the RMI, while Sections 215 and 216 of the U.S.–FSM compact and sections 216 and 217 of the U.S.–RMI compact detail contributions to the FSM and RMI trust funds. The increase in RMI grants from fiscal year 2013 to 2014 is due to a $2 million increase in payments to be made available for addressing the special needs of the community at Ebeye and other Marshallese communities within the Kwajalein Atoll.

The cumulative inflation adjustment largely offsets the amount of the decrement, resulting in a relatively steady nominal amount of compact sector grants after inflation adjustments (see fig. 10). However, because the inflation adjustment is not equal to full inflation, the value of compact sector grants continues to decline in real terms.

Figure 10: U.S. Grants and Trust Fund Contributions to Be Provided to the FSM and RMI under the Amended Compacts, After Partial Adjustments for Inflation, Fiscal Years 2004 through 2023



Source: GAO analysis of the Compacts of Free Association, as Amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia (FSM) and the Government of the Republic of the Marshall Islands (RMI) (Pub. L. 108-188); and the U.S. Department of the Interior, Office of Insular Affairs Budget Justifications and Performance Information, Fiscal Year 2018. | GAO-18-415

Notes: Sections 211 and 216 of the amended FSM compact and sections 211 and 217 of the amended RMI compact detail grants to the FSM and the RMI, while Sections 215 and 216 of the U.S.–FSM compact and sections 216 and 217 of the U.S.–RMI compact detail contributions to the FSM and RMI trust funds. As agreed in the amended compacts, the dollar amounts shown are adjusted each fiscal year for inflation by the percentage that equals two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator, or 5 percent, whichever is less in any one year, using the beginning of 2004 as a base. Amounts shown for fiscal years 2004 through 2016 are actual amounts; amounts for 2017 through 2023 are projected by the U.S. Department of the Interior. The increase in RMI grants from fiscal year 2013 to 2014 is due to a $2 million increase in payments to be made available for addressing the special needs of the community at Ebeye and other Marshallese communities within the Kwajalein Atoll.

Appendix III: Compact Grants Supporting Health and Education in the FSM and RMI

U.S. grants that end in 2023 play a significant role in the budgets of the FSM states and the RMI in the health and education sectors. The colleges of both countries have also relied on compact sector grants but rely even more on Pell grants to support their operation.

FSM

FSM states rely on U.S. grants scheduled to end in 2023 for the majority of their health and education expenditures. In fiscal year 2016, compact sector grants and the SEG supported 60 percent or more of health expenditures and 82 percent or more of state education expenditures. Table 3 shows the states' health and education expenditures of compact sector grants and the supplemental education grant (SEG) in fiscal year 2016. In fiscal years 2012 through 2016, compact sector grants and the SEG supported 56 to 99 percent of FSM states' health expenditures and 82 to 100 percent of FSM states' education expenditures.

Table 3: FSM States' Health and Education Expenditures of Compact Sector and Supplemental Education Grants (SEG), Fiscal Year 2016

Dollars in millions

		Expenditures of compact sector grants and SEG[a]	
Sector and state	**Total expenditures (dollars)**	**Amount (dollars)**	**Percentage of total expenditures**
Health			
Chuuk	10.9	9.5	87
Kosrae	3.5	2.1	60
Pohnpei	8.3	5.8	70
Yap	5.6	3.5	62
Education			
Chuuk	15.5	14.6	95
Kosrae	4.4	3.7	82
Pohnpei	10.9	9.8	89
Yap	6.1	5.5	90

Source: GAO analysis of FSM states' fiscal year 2016 single audit reports. | GAO-18-415

[a]The SEG was used only in the education sector. The amounts and percentages shown for the education sector do not include the College of Micronesia–FSM.

U.S. compact sector, supplemental education, and other grants also supported approximately 76 percent of the average $21 million in annual expenditures of the College of Micronesia–FSM, an FSM government component unit, in fiscal years 2012 through 2016. Compact sector grants and the SEG, each of which end in 2023, supported approximately 15 percent of the college's annual expenditures. Pell grants, which provide support for education expenses for qualifying students, supported more than half of the college's annual expenditures. College officials told us that the college would be unable to operate without Pell grants. According to officials from the U.S. Department of Education, the college will remain eligible after 2023 to receive Pell grants that benefit its students as long as such grants are available to institutions and students in the United States (see app. IV).

RMI

The RMI relies on U.S. grants scheduled to end in 2023 for health and education expenditures. In fiscal year 2016, compact sector and supplemental education grants scheduled to end in 2023 supported approximately 25 percent of RMI health expenditures and approximately 59 percent of RMI education expenditures (see table 4). Kwajalein-related grants increased these percentages to 32 percent for health and 66 percent for education. In total, in fiscal years 2012 through 2016, compact sector grants and the SEG supported approximately 58 percent of RMI education expenditures and 29 percent of health expenditures. During this period, the percentage of education expenditures supported by compact sector and supplemental education grants scheduled to end in 2023 remained relatively steady and the percentage of health expenditures decreased slightly.

Table 4: RMI Health and Education Expenditures of Compact Sector and Supplemental Education Grants (SEG) and Kwajalein-Related Grants, Fiscal Year 2016

Dollars in millions

		Expenditures of compact sector grants and SEG[a]		Expenditures of Kwajalein-related grants		Total expenditures of compact sector, SEG, and Kwajalein-related grants[a]	
Sector	Total government expenditures (dollars)	Amount (dollars)	Percentage of total expenditures	Amount (dollars)	Percentage of total expenditures	Amount (dollars)	Percentage of total expenditures
Health	29.5	7.4	25	2.0	7	9.4	32
Education	28.9	17.1	59	2.1	7	19.2	66

Source: GAO analysis of RMI fiscal year 2016 single audit reports. | GAO-18-415

[a]The SEG was used only in the education sector. Health total is from the RMI Ministry of Health and Environment. The amounts and percentages shown for the education sector do not include the College of the Marshall Islands.

U.S. compact sector, supplemental education, and other grants also supported approximately half of the average $11.9 million in annual expenditures of the College of the Marshall Islands, an RMI government component unit, in fiscal years 2012 through 2016. Compact sector grants and the SEG, each of which end in 2023, supported approximately 8 percent of the college's annual expenditures. Pell grants supported about 39 percent of the college's expenditures. According to officials from the U.S. Department of Education, the college will remain eligible after 2023 to receive Pell grants that benefit its students, as long as such grants are available to institutions and students in the United States (see app. IV). Also in fiscal years 2012 through 2016, compact sector and supplemental education grants scheduled to end in 2023 supported about half of the expenditures of the RMI government component unit, the Marshall Islands Scholarship, Grant, and Loan Board, which provides financial assistance for educational and training opportunities. Kwajalein-related compact grants that do not end in 2023 supported an additional 13 percent of the board's expenditures.

Appendix IV: Status of U.S. Grants and Programs in the FSM and RMI After 2023

The amended compacts, compact-related agreements, the amended compacts' implementing legislation, and other U.S. laws provide grants or eligibility for U.S. programs and services for the FSM and RMI. The amended compacts provided compact sector, Kwajalein-related, and audit grants. Under current law, compact sector and audit grants are each scheduled to end in 2023, but the RMI military use and operating rights agreement (MUORA) extended the time frame of Kwajalein-related compact grants for as long as the agreement is in effect. The amended compacts' implementing legislation provided additional grants, including authorizing a supplemental education grant (SEG), and identified several specific U.S. programs as available to the FSM and RMI. Under current law, the additional grants end in 2023 but the statutory authorizations for some programs identified in Pub. L. No. 108-188 provide for the continued eligibility of the FSM and RMI to receive benefits under the programs. However, after fiscal year 2023, the FSM and RMI will no longer be eligible under current U.S. law for some programs that the SEG replaced. The compact-related programs and services agreements with each country identify additional programs and services that the United States makes available to the FSM and RMI. While these agreements will end in 2024, under current law, some U.S. agencies may continue to provide programs and services similar to those provided in the agreement under other authorities. Based on the status of current law, the FSM's and RMI's eligibility for other programs we identified that have been provided under other current U.S. laws will not change after fiscal year 2023.

Compact Sector and Audit Grants End in 2023, but Kwajalein-Related Grants for the RMI Will Continue

Under current law, compact sector grants provided to the FSM and the RMI under their compact sections 211(a) are scheduled to end in 2023. However, the RMI is scheduled to continue to receive $7.2 million, partially inflation adjusted, related to the U.S. military base in Kwajalein Atoll and provided under section 211(b) of its compact. Under the terms of the RMI MUORA, the United States agreed to provide these Kwajalein-related grants for as long as the MUORA is in effect. The MUORA continues until 2066 and may be extended at the discretion of the United States until 2086.[1] The amended RMI compact provides for $18 million, partially inflation adjusted, in annual payments to the RMI government to compensate for impacts from the U.S. Army Garrison–Kwajalein Atoll. These payments will continue for as long as the MUORA is in effect.

[1]The United States may terminate the RMI MUORA after 2023 with 7 years advance notice. If termination occurs prior to 2053, the United States is required to make a termination payment equivalent to 1 or more years of annual grant assistance.

Annual compact grants of up to $500,000 (not inflation adjusted) to each country to pay for required annual audits of compact grants are scheduled to end in 2023. See table 5 for a summary of compact sector, Kwajalein-related, and audit grants.

Table 5: Status under Current Law of Compact Sector, Kwajalein-Related, and Audit Grants to the FSM and RMI after Fiscal Year 2023

Country receiving assistance	Compact grant name and reference	Description	Status under current law as of end of fiscal year 2023[a]
FSM and RMI	§ 211(a) Compact Sector Grants	Economic assistance directed to specific sectors, with a focus on Health and Education. The base amount of the grants declines yearly in fiscal years 2004 through 2023.[b] In 2004, FSM grants totaled $76.2 million. Grants will decline, before partial inflation adjustment, to $62.6 million in 2023. In 2004, RMI grants totaled $35.2 million. Grants will decline, before partial inflation adjustment, to $27.7 million in 2023.	Grants will end.
RMI	RMI compact § 211(b)(1) Ebeye Special Needs	$5.1 million annually, partially inflation adjusted, to address the special needs of the community at Ebeye and other Marshallese communities within Kwajalein Atoll.[c]	Grants will continue as long as the MUORA is in effect.
RMI	RMI compact § 211(b)(2) Ebeye Special Needs	$1.9 million annually, partially inflation adjusted, to address the special needs of the community at Ebeye and other Marshallese communities within Kwajalein Atoll with emphasis on the Kwajalein landowners.	Grants will continue as long as the MUORA is in effect.
RMI	RMI compact § 211(b)(3) Kwajalein Environmental Grants	$200,000 annually, partially inflation adjusted, to support increased participation of the RMI Environmental Protection Authority in the U.S. Army Kwajalein Atoll Environmental Standards Survey and to promote the RMI government's capacity for independent analysis of the survey's findings and conclusions.	Grants will continue as long as the MUORA is in effect.
RMI	RMI compact § 212 – Kwajalein Impact and Use	$18 million annually, partially inflation adjusted, provided to the RMI government to compensate for any impacts of the U.S. military on the atoll.[d]	Payments will continue as long as the MUORA is in effect.
FSM and RMI	Audit grants provided in FSM compact § 212(b) and RMI compact § 213(b)	Annual grant assistance, not adjusted for inflation, equal to the lesser of (1) one half of the cost of the annual audit or (2) $500,000.[e]	Grants will end.

Source: GAO analysis of the Compacts of Free Association with the Federated States of Micronesia (FSM) and Republic of the Marshall Islands (RMI). | GAO-18-415

[a]Status is based on current law.

[b]The U.S. Department of the Interior (Interior) estimates that, with partial inflation adjustments, compact sector grants in fiscal year 2023 will total approximately $82.0 million for the FSM and approximately $36.3 million for the RMI, including 211(a) and 211(b) funds.

[c]Ebeye Special Needs grants to the RMI under §211(b)(1) provided $3.1 million annually in fiscal years 2004 through 2013 and $5.1 million annually thereafter.

[d]Interior estimates that, with partial inflation adjustments, the payment to the RMI for Kwajalein impact and use in fiscal year 2023 will be approximately $23.6 million.

[e]In each year through fiscal year 2018 the amount provided through audit grants to the FSM and the RMI has been the maximum of $500,000.

FSM and RMI are No Longer Eligible for Many Programs Replaced by the Supplemental Education Grant

The supplemental education grant (SEG) authorized by the amended compacts' implementing legislation is scheduled to end in fiscal year 2023 and, under current law, FSM and RMI eligibility for most programs that the SEG replaced will not resume after fiscal year 2023. Absent changes to current law, the FSM and RMI will not be eligible after fiscal year 2023 for the following programs that the SEG replaced during fiscal years 2005 through 2023: U.S. elementary and secondary education grant programs, adult education and literacy programs, career and technical education programs, job training programs, and Head Start early education programs. However, under other provisions of current law, qualifying individuals in the FSM and RMI will be eligible after fiscal year 2023 for undergraduate education grants and work-study programs that the SEG replaced. See table 6.

Table 6: FSM and RMI Eligibility under Current Law after Fiscal Year 2023 for Programs Replaced by the Supplemental Education Grant (SEG) Provided in the Amended Compacts' Implementing Legislation, Pub. L. No. 108-188

Program description	Eligibility under current law as of end of fiscal year 2023[a]
Department of Education: Supplemental Education Grant (SEG) Authorization of appropriations of $12.23 million for the Federated States of Micronesia (FSM) and $6.1 million to the Republic of the Marshall Islands (RMI), adjusted for inflation for each of fiscal years 2005 through 2023 in lieu of eligibility for the various education, health, and labor programs listed below.[b]	SEG ends. Eligibility varies for programs replaced by the SEG after 2023. See below for FSM and RMI eligibility for programs replaced by the SEG.
Programs replaced by the SEG during fiscal years 2005-2023	
Department of Education: Part A of title I of the Elementary and Secondary Education Act of 1965 (Improving Basic Programs Operated by Local Educational Agencies).	Not eligible
Department of Education: Title I of the Carl D. Perkins Vocational and Technical Education Act of 1998 (Career and Technical Education).	Not eligible
Department of Education: Subpart 3 of part A of title IV of the Higher Education Act of 1965 (Federal Supplemental Educational Opportunity Grants).	Eligible
Department of Education: Part C of title IV of the Higher Education Act of 1965 (Federal Work-Study Programs)	Eligible

Program description	Eligibility under current law as of end of fiscal year 2023[a]
Department of Education: Title II of the Workforce Investment Act of 1998.[c] (Adult Education and Literacy programs.)	Not eligible
Department of Health and Human Services: Head Start Act (early childhood education, health, and nutrition services for low-income children and their families.)	Not eligible
Department of Labor: Title I of the Workforce Investment Act of 1998.[c] (Statewide and local workforce investment systems, Job Corps, and various national programs such as Native American, migrant, and veterans programs.)	Not eligible

Source: GAO analysis of Pub. L. No. 108-188 and the U.S. Code. | GAO-18-415

[a]Eligibility is based on current law. The availability of grants and programs in the future is subject to the availability of appropriations provided for that purpose.

[b]In fiscal year 2017, $16.7 million was appropriated to the Secretary of Education for the SEG: $11.1 million for the FSM and $5.6 million for the RMI. In each country, this amount is lower than the authorized SEG amount and is also lower than the authorized amount after inflation adjustments.

[c]The Workforce Investment Act of 1998 was repealed and replaced by the Workforce Innovation and Opportunity Act (Pub. L. 113-128), which does not include eligibility for the FSM and RMI.

Some Programs and Services in the Programs and Services Agreement Will End, while Others May Continue under Other Authorities

Although the programs and services agreements with the FSM and RMI will end in fiscal year 2024, current U.S. law enables U.S. agencies to continue providing some programs and services now provided under the agreements. No current provisions of U.S. law will enable the Federal Emergency Management Agency (FEMA) to provide disaster response funding or enable the Federal Deposit Insurance Corporation to provide deposit insurance or the U.S. Postal Service to provide services to the FSM and RMI after the agreements end. However, the National Weather Service, the U.S. Department of Transportation’s (DOT) Federal Aviation Administration (FAA), and the U.S. Agency for International Development (USAID) could, under other legal authorities, provide services similar to those they now provide under the programs and services agreements.

- **National Weather Service.** The programs and services agreements authorize the National Weather Service to fund the operations of weather stations in the FSM and RMI, which it can continue to fund after the end of the Agreements under other authorities, according to Department of Commerce officials.
- **Federal Aviation Administration.** The programs and services agreements authorize DOT’s FAA to provide technical assistance in the FSM and RMI, which it can continue to provide after the end of the Agreements under other provisions of current U.S. law. However,

DOT officials stated that FAA would require new bilateral agreements with the FSM and the RMI in order for the countries to continue to receive the civil aviation safety services that FAA currently provides under the programs and services agreements. The FAA would also seek reimbursement for any technical assistance it provides to the FSM and RMI. With regard to the civil aviation economic services of the programs and services agreements, DOT officials stated that, while the FSM and RMI could voluntarily decide to allow U.S. air carriers to continue operations in the FSM and RMI, new bilateral agreements would be needed to assure that result.[2]

- **U.S. Agency for International Development.** Following a U.S. presidential disaster declaration, FEMA provides the funding for disaster relief and reconstruction, which is programmed through USAID.[3] Under current law, FEMA funds will no longer be available for this purpose once the agreements end; however, USAID will be able to provide foreign disaster assistance funding to the FSM and RMI under the same terms as it provides this assistance to other countries. After the programs and services agreements end, FEMA will be able to support disaster relief efforts only if USAID or the countries request it to do so on a reimbursable basis.

In addition, according to State and Interior officials, telecommunications-related services that the two agencies provide to the FSM and RMI under the programs and services agreements will continue as long as the FSM and RMI provide appropriate authorization for such services. Table 7 shows the status after fiscal year 2024 of programs and services currently provided to the FSM and the RMI under the agreements.

[2]An FAA official in the Office of the Airports noted that three FSM and RMI airports (Majuro, Kwajalein, and Yap) are also extended operations sites that provide emergency diversionary landing sites. U.S. Aviation regulations require flight paths to be within a certain range of an airport in case of emergency. Therefore, without the emergency diversionary landing sites at FSM and RMI airports, planes transiting the Pacific would have to fly different and longer routes, increasing airline operating costs, according to DOT.

[3]In recent years USAID has programmed FEMA-provided funds for disaster response and reconstruction in the FSM states of Chuuk and Yap to meet immediate humanitarian needs and facilitate recovery from the impact of Typhoon Maysak in March and April 2015 and for disaster assistance in the RMI in response to a prolonged drought conditions in 2015-2016.

Table 7: Status under Current Law of Programs and Services Identified in U.S.-FSM and U.S.-RMI Amended Compacts' Programs and Services Agreements after the Agreements End in Fiscal Year 2024

Country receiving assistance	U.S. agency	Program or service	Description	Status under current law after programs and services agreements end[a]
Federated States of Micronesia (FSM) and Republic of the Marshall Islands (RMI)	Department of Commerce National Weather Service	Weather services and related programs	The National Weather Service provides funding for the operation of weather stations in Majuro, RMI and in Pohnpei, Chuuk, and Yap states in the FSM.	According to Department of Commerce officials, the Secretary of Commerce may continue funding if the Secretary determines that maintaining service at these locations is essential to proper execution of Commerce Department duties.
FSM	Federal Deposit Insurance Corporation	Federal deposit insurance	The Federal Deposit Insurance Corporation insures the Bank of the FSM.	According to Federal Deposit Insurance Corporation officials, the corporation will not have authority to insure a foreign-chartered institution in the FSM.
FSM and RMI	Federal Emergency Management Agency (FEMA) and U.S. Agency for International Development (USAID)	Disaster services and related programs	FEMA provides disaster-related preparedness grants and provides USAID with funds to support disaster relief and reconstruction following a U.S. Presidential disaster declaration. The disaster response itself is implemented by USAID.	According to FEMA officials, FEMA will not have the authority to provide assistance directly to the FSM and RMI or to provide funding to USAID for such purposes. FSM and RMI will remain eligible to receive assistance from USAID on the same terms as other foreign countries pursuant to the Foreign Assistance Act.
FSM and RMI	Postal Service	Postal services and related programs	The Postal Service provides transportation of mail to and from each country, includes each country in the U.S. zip code system, and has committed to assist each country with the acquisition of membership in international postal unions, upon request.[b]	According to U.S. Postal Service officials, the continuation of service will depend upon the ability of the FSM and RMI to secure membership in the Universal Postal Union. If they do not become members of the Universal Postal Union, then the Postal Service will need to negotiate beneficial bilateral arrangements with the countries.
FSM and RMI	Department of State and Department of the Interior	Telecommunications services and related programs.	Frequency spectrum management within the FSM and RMI and the operation of tele-communication services of the Government of the United States necessary to fulfill its obligations under the amended compacts.	According to State and Interior officials, services may continue if the FSM or the RMI provides appropriate authorization to the United States to provide such services.
FSM and RMI	Department of Transportation (DOT) Federal Aviation Administration (FAA)	Civil aviation safety services and related programs	FAA provides assistance with airport navigational and safety services.	According to FAA officials, similar assistance may be provided under various FAA authorities, but FAA would be required to seek reimbursement for these services.

Country receiving assistance	U.S. agency	Program or service	Description	Status under current law after programs and services agreements end[a]
FSM and RMI	DOT FAA	Civil aviation economic services and related programs	Permits FSM and RMI airlines to operate between U.S. destinations. Provides technical assistance to the FSM with regulation of air service.	FSM and RMI airlines will no longer be permitted to operate between U.S. destinations. According to DOT, FSM, and RMI officials, no FSM or RMI air carriers provide service to U.S. destinations. According to FAA officials, technical assistance may be provided under various FAA authorities, but FAA would be required to seek reimbursement for these services.

Source: GAO analysis of the compact programs and services agreements, the U.S. Code, and discussions with agency officials. | GAO-18-415

[a]Status is based on current law. The availability of grants and programs in the future is subject to the availability of appropriations provided for that purpose.

[b]At present, according to the U.S. Postal Service, the United States has received no request for assistance in acquiring membership in international postal unions from either country. The Department of the Interior has provided an average of $2.5 million to reimburse the costs of the U.S. Postal Service to provide services to the FSM and RMI, but, according to the Postal Service, the reimbursement by the department has not covered its costs in each year that it has provided services. In fiscal years 2015 and 2016, according to the U.S. Postal Service, the annual reimbursement shortfall experienced by the U.S. Postal Service averaged $8.7 million per year. Appendix X provides more information from the U.S. Postal Service regarding the amount of the reimbursement shortfall.

Programs Identified in the Amended Compacts' Implementing Legislation Generally Continue after Fiscal Year 2023

Additional grants provided to the FSM and the RMI under the amended compacts' implementing legislation will end in fiscal year 2023, but the countries' eligibility for programs now provided under that legislation will generally continue under current U.S. law. Grants provided under the amended compacts' implementing legislation for (1) judicial training in the FSM and the RMI, and (2) agricultural and planting programs on the RMI's nuclear-affected Enewetak Atoll are scheduled to end. However, under current U.S. law, legal authorities permitting the operation of other programs would remain available to the FSM and RMI after fiscal year 2023. Eligibility under these legal authorities continues either because the amended compacts' implementing legislation does not specify an ending date or because other provisions in current U.S. law make the FSM and RMI eligible for the program.

Programs provided in the amended compacts' implementing legislation include U.S. Department of Agriculture Rural Utilities Service grant and loan programs; U.S. Department of Education Pell grants for higher education and grants under Part B of the Individuals with Disabilities Education Act for children with disabilities; programs for nuclear-affected areas in the RMI; and additional programs provided by the Departments of Commerce and Labor as well as law enforcement assistance provided by the U.S. Postal Service. See table 8 for a summary of the programs identified in the amended compacts' implementing legislation and their status as of the end of fiscal year 2023.

Table 8: Status under Current Law after Fiscal Year 2023 of Programs and Grants Provided in the U.S.-FSM and U.S.-RMI Amended Compacts' Implementing Legislation, Pub. L. No. 108-188

Country receiving assistance	U.S. agency	Program or grant	Description	Status under current law as of end of fiscal year 2023[a]
Federated States of Micronesia (FSM) and Republic of the Marshall Islands (RMI)	Department of Agriculture	Rural Utilities Service grants and loans	The Rural Utilities Service provides financing and grants to support infrastructure development such as electricity, telecommunications, and water and wastewater systems.	Eligibility will continue.
FSM and RMI	Department of Commerce	Economic programs and services	Programs and Services of the Department of Commerce Economic Development Administration and relating to tourism and to marine resource development.	Eligibility will continue.
FSM and RMI	Department of Education	Pell grants	Grants for postsecondary education expenses to qualifying students based on financial need.	Eligibility will continue.
FSM and RMI	Department of Education	Special education grants	Individuals with Disabilities Education Act grants to local school systems for the education of children with disabilities.	Eligibility will continue.
RMI	Department of Energy	Radiological Health Care Program	Medical care and logistical support thereto for the remaining members of the population exposed to radiation by U.S. nuclear testing.	Program will continue.
RMI	Department of Energy	Runit Island Environment Monitoring	Monitoring at least every four years of the containment structure and groundwater of Runit island in the nuclear-affected Enewetak atoll.	Program will continue.
FSM and RMI	Department of the Interior	Judicial training grants	$300,000 annually, partially adjusted for inflation, for each fiscal year from 2004 through 2023 for the training of judges and officials of the judiciary.	Grants will end unless Congress authorizes and appropriates additional funds.
RMI	Department of the Interior	Planting and Agricultural Maintenance Program on Enewetak	$1.3 million, partially adjusted for inflation, for each fiscal year from 2004 through 2023 to restore vegetation on Enewetak, a nuclear-affected atoll.	Program will end unless Congress authorizes and appropriates additional funds.
RMI	Department of the Interior	Four Atoll Health Care	Health care for nuclear-affected areas.	Program will continue.
FSM and RMI	Department of Labor	Job Corps[b]	The programs and services of the Department of Labor under subtitle C of title I of the Workforce Investment Act of 1998 (29 U.S.C. 2881 et seq.; relating to Job Corps).[c]	Eligibility will continue.

Country receiving assistance	U.S. agency	Program or grant	Description	Status under current law as of end of fiscal year 2023[a]
FSM and RMI	Postal Service	Law enforcement assistance	Technical and training assistance, including training and equipment for postal inspection of illicit drugs and other contraband.	Program will continue.

Source: GAO analysis of Pub. L. No. 108-188, the U.S. Code, and discussions with agency officials. | GAO-18-415

[a]Status is based on current law. The availability of grants and programs in the future is subject to the availability of appropriations provided for that purpose.

[b]According to the U.S. Department of Labor, there are currently no Job Corps activities in either the FSM or the RMI.

[c]The Workforce Investment Act of 1998 was repealed and replaced by the Workforce Innovation and Opportunity Act (Pub. L. 113-128).

Programs Identified in Other Legislation Generally Continue after Fiscal Year 2023

In addition to being eligible for the programs provided through the compact, its associated agreements, and the amended compacts' implementing legislation, the FSM and RMI are also eligible for a number of programs under other provisions of current U.S. law. The FSM and RMI have each received funds from the U.S. Department of Agriculture for forestry and rural housing programs, multiple Health and Human Services public health program grants, Interior technical assistance and historic preservation programs, and the DOT FAA airport improvement program, among others. Under current U.S. law, the legal authorities permitting the provision of these programs in the FSM and RMI would not necessarily change after 2023. Table 9 shows the FSM's and RMI's eligibility for these additional grants and programs under current law after fiscal year 2023.

Table 9: FSM and RMI Eligibility under Current Law after Fiscal Year 2023 for Other U.S. Grants and Programs That Have Been Made Available

Country receiving assistance	U.S. agency	Type of grant or program	Description	Status under current law as of end of fiscal year 2023[a]
Federated States of Micronesia (FSM) and Republic of the Marshall Islands (RMI)	Department of Agriculture	Forestry Service programs	Assistance with forestry planning, forest stewardship and preservation, and wildfire prevention and suppression.	Eligibility will continue.
FSM and RMI, but currently active only in RMI	Department of Agriculture	Mutual Self-Help Technical Assistance Grant	Assistance to lower-income families in rural areas in building their own homes. Funding is provided to an entity that must give technical assistance.	Eligibility will continue, according to Department of Agriculture officials.

Country receiving assistance	U.S. agency	Type of grant or program	Description	Status under current law as of end of fiscal year 2023[a]
FSM and RMI, but currently active only in RMI	Department of Agriculture	Section 502 Single Family Housing Loan and Guaranteed Loan Programs	Assistance to low-income applicants to obtain decent, safe and sanitary housing in eligible rural areas.	Eligibility will continue.
FSM and RMI	Department of Agriculture	Section 504 Housing Repair & Rehabilitation Loans and Grants	Assistance to very low-income applicants 62 years or older to remove health and safety hazards or repair their homes when they are located in rural areas with populations of 20,000 or less.	Eligibility will continue.
FSM and RMI	Department of Education	TRIO Talent Search and TRIO Upward Bound	Outreach and student services programs designed to identify and provide services for individuals from disadvantaged backgrounds such as low-income individuals, first-generation college students, and individuals with disabilities.	Eligibility will continue as long as the FSM or RMI institution receiving the grant remains an approved institution as defined in 20 U.S.C. § 1002(a)(2).
RMI	Department of Energy	Environmental Monitoring Program	Periodic monitoring of the four nuclear-affected atolls—Bikini, Enewetak, Rongelap and Utrik	Program will continue.
FSM and RMI	Department of Health and Human Services	Multiple programs authorized by the Public Health Services Act	Public health, medical, and disease control and prevention grants.	Eligibility will continue according to Health and Human Services officials.
FSM and RMI	Department of the Interior	Historic Preservation Grants in Aid	Historic preservation and community projects focused on heritage preservation.	Eligibility will continue.
FSM and RMI	Department of the Interior	Technical assistance grants	Grants for short-term, noncapital projects. Priorities include accountability; financial management; economic development; training and education; energy; life; safety and health issues, among others.	Eligibility will continue to the extent such assistance may be provided to States, territories or units of local government.
FSM and RMI	National Science Foundation grants	Grants to improve science, technology, engineering, and math education	Currently: Advancing Informal Science Learning/Geo-literacy Education in Micronesia and Advanced Technological Education/Partnership for Advanced Marine and Environmental Science Training for Pacific Islanders.	Eligibility will continue.
FSM and RMI	Department of State	Grants to combat trafficking in persons	Current project focuses on raising awareness of trafficking in persons; boosting law enforcement capacity, and establishment of national referral mechanisms for the protection of victims of trafficking.	Eligibility will continue.

Country receiving assistance	U.S. agency	Type of grant or program	Description	Status under current law as of end of fiscal year 2023[a]
RMI	Department of State	Humanitarian demining	Clearance of explosive remnants of war on inhabited areas of Wotje Island, Wotje Atoll, Jaluit Island, and Jaluit Atoll.	Eligibility will continue.
FSM and RMI	Department of Transportation	Airport Improvement Program[b]	Grants to public agencies for the planning and development of public-use airports.	Eligibility will continue.
FSM and RMI	USAID	Pacific-American Climate Fund	Grants to civil society organizations to build funding and management capacity for programs to respond to climate change challenges.	This program will end before 2023, but eligibility for similar programs will continue, according to USAID officials.

Source: GAO analysis of Pub. L. No. 108-188 and the U.S. Code; and discussions with agency officials. | GAO-18-415

[a]Status is based on current law. The availability of grants and programs in the future is subject to the availability of appropriations provided for that purpose.

[b]Airport Improvement Program grant authority expires September 30, 2018.

Appendix V: Compact Trust Fund Baseline Outcomes Calculated with Varying Return Assumptions

In order to the test the sensitivity of our compact trust fund projections to assumptions about the future rate of return, we also performed our Monte Carlo analysis using alternate rates of return. We projected the compact trust fund disbursements and balance under current compact trust fund rules on the basis of a 6 percent net return and also estimated the trust fund on the basis of 5 percent, 7 percent, and 8 percent net returns. Higher rates of return would improve the outlook for each compact trust fund. However, even with higher rates of return, our analysis shows a high likelihood that available compact trust fund disbursements will not reach an amount equivalent to maximum disbursements permitted by the compact trust fund agreement (i.e., the inflation-adjusted amount of fiscal year 2023 annual grant assistance, as defined by the trust fund agreements), a continuing risk of zero disbursements, and a decreasing likelihood that the fund will maintain or exceed its inflation-adjusted balance in fiscal year 2023. See tables 10 and 11 for our projections of FSM and RMI compact trust fund disbursements, likelihood of 1 or more years with zero disbursement, and likelihood of maintaining or exceeding its inflation-adjusted fiscal year 2023 value.

Table 10: FSM Compact Trust Fund Baseline Outcomes Calculated with Varying Return Assumptions

	Projected average compact trust fund disbursement (dollars in millions)				Projected average compact trust fund disbursement as a percentage of maximum disbursement				Percentage likelihood of 1 or more years with zero disbursement in the given 10-year period				Percentage likelihood of trust fund balance maintaining or exceeding inflation-adjusted fiscal year 2023 value			
Mean net rate of return	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY33	FY43	FY53	FY63
5 percent	70	44	33	26	77	40	25	16	52	87	94	96	8	3	2	1
6 percent	75	54	44	36	82	49	33	22	41	78	88	92	13	7	5	4
7 percent	79	66	58	52	87	59	43	32	32	67	79	85	19	13	10	9
8 percent	83	77	74	72	91	69	54	43	22	53	66	73	28	22	19	18

Legend: FY = fiscal year

Source: GAO analysis of compact trust fund documents. | GAO-18-415

Notes: We used the compact trust fund’s unaudited balance at the end of fiscal year 2017 as the starting balance. We assumed that the trust fund’s annual return will have a normal distribution with a standard deviation of 13 percent.

We calculated the average disbursement in the given time periods by averaging 10-year period simulated disbursements (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging the ratio of simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given time period (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement among the 10,000 simulated cases in each given time period.

We calculated the likelihood of the fund balance maintaining its inflation-adjusted fiscal year 2023 value by simulating 10,000 cases and counting those in which the simulated balance does not equal or exceed the projected inflation-adjusted 2023 balance.

Table 11: RMI Compact Trust Fund Baseline Outcomes Calculated with Varying Return Assumptions

	Projected average compact trust fund disbursement (dollars in millions)				Projected average compact trust fund disbursement as a percentage of maximum disbursement				Percentage likelihood of 1 or more years with zero disbursement in the given 10-year period				Percentage likelihood of trust fund balance maintaining or exceeding inflation-adjusted fiscal year 2023 value			
Mean net rate of return	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY33	FY43	FY53	FY63
5 percent	28	28	28	26	93	78	62	48	21	47	63	73	30	22	18	15
6 percent	28	31	33	34	95	85	74	63	15	34	47	56	41	35	31	29
7 percent	29	33	38	42	97	91	84	77	10	22	31	38	52	49	48	47
8 percent	29	35	41	47	98	95	91	87	7	14	19	23	62	64	65	66

Legend: FY = fiscal year

Source: GAO analysis of compact trust fund documents. | GAO-18-415

Notes: We used the compact trust fund's unaudited balance at the end of fiscal year 2017 as the starting balance. We assumed that the trust fund's annual return will have a normal distribution with a standard deviation of 13 percent.

We calculated the average disbursement in the given time periods by averaging 10-year period simulated disbursements (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging the ratio of simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given time period (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement among the 10,000 simulated cases in each given time period.

We calculated the likelihood of the fund balance maintaining its inflation-adjusted fiscal year 2023 value by simulating 10,000 cases and counting those in which the simulated balance does not equal or exceed the projected inflation-adjusted 2023 balance.

Appendix VI: FSM and RMI Country Trust Funds

The FSM and RMI each maintain their own country trust funds separate from the compact trust funds. These country trust funds are also available to provide a source of revenue after compact grants end at the end of fiscal year 2023. We did not independently project the future balance or potential disbursements from the FSM Trust Fund after 2023.

FSM Trust Fund

The FSM maintains its own trust fund, separate from the compact trust fund, which can provide additional resources after fiscal year 2023 to offset a reduction in resources relative to those made available as of fiscal year 2023. The FSM Trust Fund, established in 1999, has grown rapidly in recent years. In fiscal years 2012 through 2017, the FSM appropriated a total of $73.3 million for contributions to its trust fund.[1] In addition, in 2015, the FSM changed its tax law to allocate 20 percent of revenue collected by the states to state subaccounts within the FSM Trust Fund. Along with investment gains, these appropriations and contributions of tax revenue have increased the FSM Trust Fund's balance from $8 million at the end of fiscal year 2011 to $115 million as of the end of fiscal year 2017.[2] As of 2017, the FSM proposed to continue adding $10 million annually from national government surpluses into its trust fund, with the aim of achieving a balance of $250 million by fiscal year 2023 and $10 million in annual disbursements. However, as of early 2018, according to FSM officials, the FSM planned to add $15 million per year to the FSM Trust Fund and projected that the fund would have a balance of $275 million by the end of fiscal year 2023. However, like the compact trust fund, the full balance of the FSM Trust Fund is not available for disbursement. Under current FSM law, funds in the FSM Trust Fund may not be withdrawn until fiscal year 2024. In addition, according to FSM officials, the FSM can withdraw only the fund's earnings and cannot withdraw the inflation-adjusted value of the FSM Trust Fund corpus.

RMI D Account

The RMI also maintains its own trust fund—the compact trust fund's D account. Although managed alongside the compact trust fund, the D account is not subject to the same disbursement provisions as the

[1]The FSM has not made additional contributions to its compact trust fund.

[2]In comments on a draft of this report, the FSM stated that $1 million sourced from Chinese grants was deposited into the FSM Trust Fund in fiscal years 2008 and 2010.

compact trust fund's A, B, and C accounts.[3] Instead, disbursements from the D account are subject to the provisions of the agreement between Taiwan and the RMI under which Taiwan contributed the $10 million that the RMI used to establish the D account. According to the terms of this agreement, the RMI may withdraw income after consultation with Taiwan but may not withdraw funds from the D account's $10 million corpus. At the end of fiscal year 2017, the D account had a balance of $15.1 million, with $5.1 million potentially available for use by the RMI.

[3]The RMI provided a total of $2.85 million in voluntary contributions to the compact trust fund's A account in fiscal years 2015 and 2016.

Appendix VII: Potential Trust Fund Strategies and Model Results

We conducted a series of simulations to determine the likely effects of potential strategies for improving the outlook of the FSM and RMI compact trust funds. Prior studies by Graduate School USA, the Asian Development Bank, and the International Monetary Fund examined the effects of three general approaches for improving the trust funds' outlooks: (1) reducing planned disbursements from the funds, (2) making additional contributions to the funds, and (3) changing the compact trust fund disbursement policies.[1] To isolate the impact of individual changes on the compact trust fund balance and disbursements, we developed and analyzed five potential strategies based on those examined in the previous studies. Reduced disbursements and additional contributions could occur without changes to the trust fund agreement, but changes to the disbursement policies may require changing the agreements. In strategies 3, 4, and, 5, we analyzed strategies that would permit disbursement from the A account. Disbursing from the A account would require changing the compact trust fund agreements. Table 12 shows the 5 potential strategies we analyzed.

Table 12: Potential Strategies for Improving Outlook of FSM and RMI Compact Trust Funds

General approach	Potential strategy
No changes to the compact trust fund agreements	
Reduced annual trust fund disbursements	1. Annual disbursement is reduced to 30 percent below the maximum disbursement.
Additional trust fund contributions	2. Trust fund receives additional annual contributions equal to 5 percent of the country's FY 2016 GDP in fiscal years 2018 through 2023.
May require changes to the compact trust fund agreements	
Changed disbursement policies (permitting disbursement from the A account)	3. Annual disbursements are limited to 5 percent of the 3-year moving average balance of the compact trust fund or maximum allowable disbursements, whichever is lower.
	4. Target disbursement is set as the maximum allowable disbursement. The disbursement amount is decreased if the 5-year moving average balance of the compact trust fund does not meet the target compact trust fund balance.[a]
	5. Target disbursement is set as 2.1 percent[b] of the compact trust fund balance. The disbursement amount is further decreased if the 5-year moving average balance of the compact trust fund does not meet the target compact trust fund balance. The disbursement amount can grow above the maximum allowed disbursement under the compact agreement if the fund balance is sufficiently high.[c]

Legend: FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands

Source: GAO review of Graduate School USA, Asian Development Bank, and International Monetary Fund reports. | GAO-18-415

[1]Each study did not examine every strategy. In practice, these strategies could be implemented in combination. For example, the compact trust funds could both receive additional contributions and have reduced disbursements.

[a]Based on Graduate School USA's Moving Adjustment Rule (MAR).

[b]We calculated the target disbursement percentage on the basis of a 6 percent net return. The target disbursement percentage would be higher if the net rate of return were higher and would be lower if the net rate of return were lower.

[c]Based on Graduate School USA's Sustainability Adjustment for Enhanced Reliability (SAFER).

Potential Strategies That Would Not Require Changes to the Compact Trust Fund Agreement

We analyzed two potential strategies that could be implemented without changes to the trust fund agreements: reductions in the amount of disbursements and additional contributions to the trust funds.

Strategy 1: Annual disbursements are reduced below the maximum allowable disbursement. We analyzed the likely effects of reducing disbursements to an amount 30 percent below the maximum disbursement, relative to the baseline scenario, for both the FSM and the RMI compact trust funds.

- For the FSM, the average size of the disbursements would be lower in the first 10 years of our projection, fiscal years 2024 through 2033, but greater in later years. For the RMI, the average disbursement size would remain lower than the disbursement amounts we projected using the baseline scenario. Disbursement amounts would remain volatile from year to year if the balance in the C account is not sufficient to provide additional disbursements.
- For both countries, the risk of zero disbursements would be reduced, but not eliminated, in each decade.
- For both countries, the likelihood that the funds would maintain or exceed their inflation-adjusted fiscal year 2023 value after fiscal year 2023 would be higher in each decade.

Reductions in annual disbursements could be effected by the compact trust fund committees at their discretion, without changes to the compact trust fund agreements. However, reductions in annual disbursements below the maximum amount would require each country to permanently adjust to having fewer resources for their budgets and economies than the compact grants provided.

Strategy 2: Additional annual contributions are made to the trust fund in fiscal years 2018 through 2023. We analyzed the likely effects of additional contributions equivalent to 5 percent of each country's fiscal year 2016 GDP, relative to the baseline scenarios, for both the FSM and the RMI compact trust funds.

- The average size of the disbursements would be greater. Disbursement amounts would remain volatile from year to year if the balance in the C account is not sufficient to provide additional disbursements.
- The risk of zero disbursements would be reduced but not eliminated.
- The likelihood that the funds would maintain or exceed their inflation-adjusted fiscal year 2023 value after fiscal year 2023 would be higher.

Additional contributions to the FSM or RMI trust funds could be accepted at the discretion of compact trust fund committees, without changes to the compact trust agreements. However, unless the compact trust fund committees could identify other donors for these contributions, the countries would have to choose to reprogram existing revenues from other uses into compact trust fund contributions.[2] The addition of funds from other donors would have no negative impact on the trust funds' outlook if other conditions remained unchanged.

Potential Strategies That Would Permit Disbursement from the A Account

We analyzed three additional potential strategies that would involve calculating annual disbursements as a percentage of the FSM and RMI compact trust funds' balance and which would permit disbursement from the A account. Disbursing from the A account would require changing the compact trust fund agreements, necessitating negotiation and agreement between the United States and each country and statutory enactment by the U.S. Congress. In strategy 3, disbursements are calculated as a fixed percentage of the funds' moving average balance over the previous 3 years. In strategies 4 and 5, disbursements are calculated on the basis of the funds' moving average balance over the previous 5 years as well as the committees' determination of the target size for the funds' balance or disbursements. All three potential strategies would require the FSM and

[2]The amended compacts' implementing legislation includes provisions for potential additional contributions to the RMI compact trust fund in compensation for the effect of changes to the tax and trade provisions of the original compact. The Compact of Free Association Act of 1985 (Pub. L. 99-239) provided for potential compensation to the RMI of up to $20 million, with the possibility for $40 million more, if the government of the RMI could demonstrate adverse impacts on its finances and economy as a result of unilateral changes the U.S. Congress made to the tax and trade provisions in Title II of the original compact. Section 108(b) of the amended compacts' implementing legislation also included this provision. In 2009, an interagency group convened by the Department of State concluded that the RMI had reasonably demonstrated net adverse impacts. Per the terms of the amended compact, the $20 million would be deposited into the compact trust fund. In 2010, the department notified Congress of the interagency group findings. However, according to the Department of the Interior, funds have not been appropriated to make such a payment.

the RMI to exchange a reduction in resources for more predictable disbursements in the longer term.

Strategy 3: The annual disbursement is set as a fixed percentage of the fund's moving average balance over the previous 3 years, up to the maximum disbursement amount defined by the current trust fund agreement.[3] We analyzed the likely effects of limiting annual disbursements to 5 percent of the moving average balance over the previous 3 years, relative to the baseline scenario for the FSM and the RMI compact trust funds.

- In earlier years, average disbursements from the compact trust funds would be smaller than those in the baseline scenario; in later years, average disbursements would exceed those in the baseline scenario. For the FSM, the average disbursement would start to exceed that in the baseline scenario in the second decade after disbursements begin (fiscal years 2034-2043). For the RMI, the average disbursement would start to exceed that in the baseline scenario in the fourth decade after disbursements begin (fiscal years 2054-2063). Disbursement amounts would be less volatile from year to year than the volatility that could be experienced in the baseline scenario when the balance in the C account is not sufficient to provide additional disbursements.
- The risk of zero disbursements would be eliminated.
- The likelihood that the funds would maintain or exceed their inflation-adjusted fiscal year 2023 value after that year would be higher than in the baseline scenario.

Strategy 4: The amount of the annual disbursement is reduced if the compact trust fund's moving average balance over the previous 5

[3]The existing compact trust fund agreements set the maximum disbursement as the inflation-adjusted amount of annual grant assistance, as defined by the trust fund agreement, in fiscal year 2023. The trust fund committees may also approve additional amounts for special needs agreed to by the trust fund committees. We did not estimate or project amounts approved for disbursements as special needs as part of our analysis.

years is lower than a primary target amount.[4] We analyzed the likely effects of implementing this strategy, relative to the baseline scenario for the FSM and the RMI compact trust funds.

- In the FSM, the average disbursement would be lower than that in the baseline scenario in earlier years but higher than that in the baseline scenario in the fourth decade after disbursements begin (i.e., fiscal years 2054-2063). In the RMI, the average disbursement would be lower than that in the baseline scenario in earlier years but would equal that in the baseline scenario in the fourth decade after disbursements begin (i.e., fiscal years 2054-2063). Disbursement amounts would be less volatile from year to year than the volatility that could be experienced in the baseline scenario when the balance in the C account is not sufficient to provide additional disbursements.
- The risk of zero disbursements would be greatly reduced but not eliminated. In the FSM, the risk would be 55 percentage points lower than in the baseline scenario in the fourth decade after disbursements begin (i.e., fiscal years 2054-2063). In the RMI, the risk would be less than 5 percent in each decade.
- The likelihood that the funds would maintain or exceed their inflation-adjusted fiscal year 2023 value after that year would be higher than in the baseline scenario.

[4]This strategy is based on the Moving Adjustment Rule, developed by Graduate School USA. The primary target is defined by Graduate School USA and refers to a conservative benchmark for the value of the compact trust fund that is required to yield the target disbursement at a given rate of return. We developed this strategy using the technical description of the moving adjustment rule in the Graduate School USA's fiscal year 2014 Economic Review reports. Graduate School USA has continued to revise its model and, in April 2018, issued a compact trust fund analysis that uses 3-year moving averages instead of 5-year moving averages. See Graduate School USA, *Compact Trust Funds in the Freely Associated States: Mechanics and Stochastic Projections* (Honolulu, Hawaii: April 2018). The primary target is defined by Graduate School USA and refers to a conservative benchmark for the value of the compact trust fund that is required to yield the target disbursement at a given rate of return. In Graduate School USA’s analysis, the primary target is determined by dividing the target disbursement (the maximum allowable disbursement) by the 5 percent historical average long-run real geometric return of a portfolio with a chosen asset allocation. In our analysis, we used a long-run real geometric return of 3.2 percent derived from our assumed nominal arithmetic net return of 6 percent. In both analyses, disbursements are reduced by 5 percent if the 5-year moving average fund balance is below the primary target and increased by 2 percent if the ratio of the 5-year moving average fund balance divided by the primary target to last year’s distribution divided by the target distribution is greater than 1.

Strategy 5: The target disbursement is set as 2.1 percent of the compact trust fund's balance in fiscal year 2024.[5] The disbursement amount is further decreased if the fund's moving average balance over the previous 5 years is lower than the primary target balance.[6] Our analysis projected the following effects of implementing this strategy relative to the baseline scenario for the FSM and the RMI compact trust funds:

- For both countries, the average disbursement would be smaller than that in the baseline scenario in the first 3 decades after disbursements begin (i.e., fiscal years 2024-2053) but would exceed that in the baseline scenario in the fourth decade. Disbursement amounts would be less volatile from year to year than the volatility that could be experienced in the baseline scenario between 2024 and 2063 when the balance in the C account is not sufficient to provide additional disbursements.
- The risk of zero disbursements would be almost eliminated.[7]
- The likelihood that the funds would maintain or exceed their inflation-adjusted fiscal year 2023 value would be much higher.

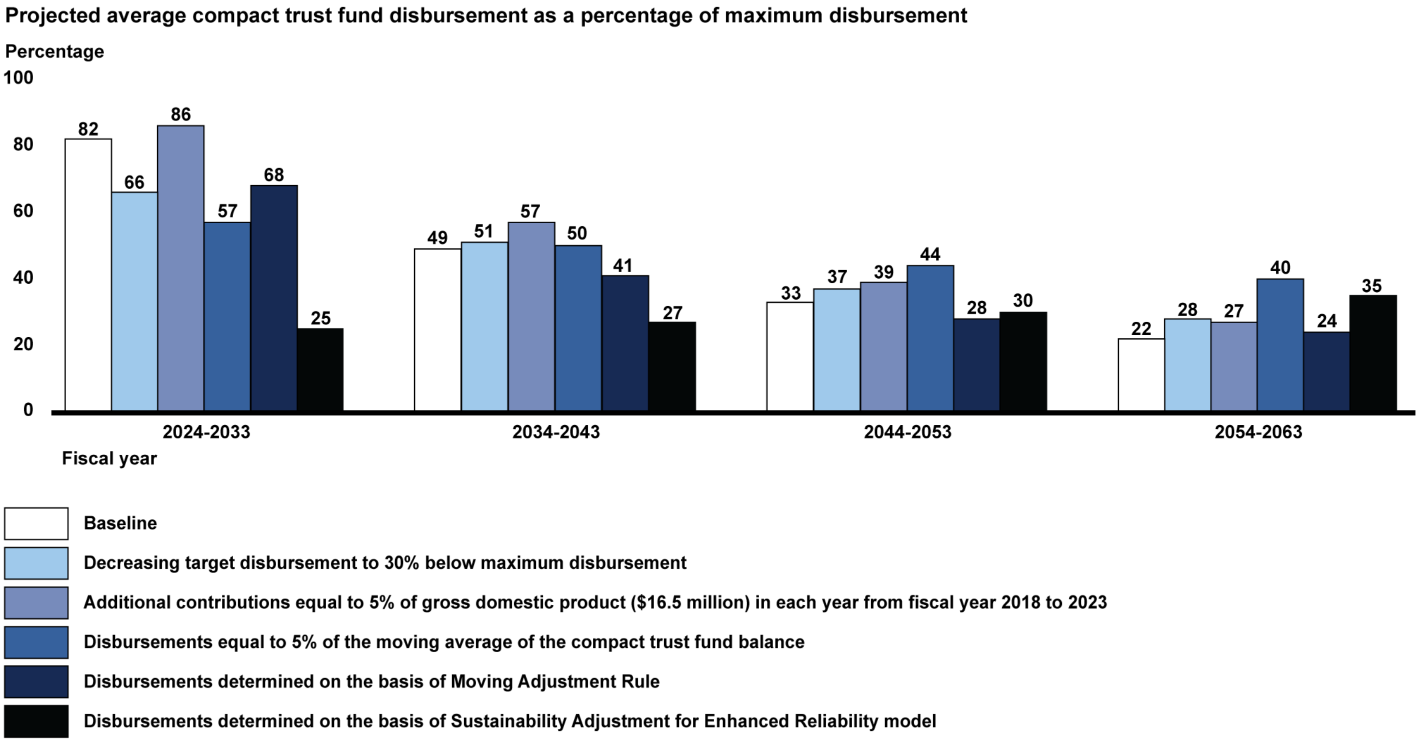
[5]This strategy is based on the Sustainability Adjustment for Enhanced Reliability (SAFER) model, developed by Graduate School USA. According to Graduate School USA, the sustainability adjustment for enhanced reliability is a method that optimizes for a chosen asset allocation's risk and return characteristics. In both the Graduate School USA analysis and our analysis, the initial target disbursement is determined by multiplying the compact trust fund balance in fiscal year 2023 by the long-run real geometric return divided by a constant number (called the sustainability adjustor). For our analysis, we calculated the initial target disbursement percentage on the basis of a 3.2 percent long-run real geometric return and a sustainability adjustor of 1.5. The target disbursement percentage would be higher if the long-run real geometric return were higher and would be lower if the long-run real geometric return were lower. We developed this strategy using the technical description of the sustainability adjustment for enhanced reliability in Graduate School USA's fiscal year 2014 Economic Review reports. Graduate School USA has continued to revise its model and, in April 2018, issued an updated review that uses 3-year moving averages instead of 5-year moving averages and a 1.67 sustainability adjustor instead of 1.5. See Graduate School USA, *Compact Trust Funds in the Freely Associated States: Mechanics and Stochastic Projections* (Honolulu, Hawaii: April 2018).

[6]The primary target balance is determined by dividing the initial target disbursement (2.1 percent of the compact trust fund on the basis of a 6 percent net return) by the long-run inflation-adjusted average geometric return on the compact trust fund (3.2 percent on the basis of a 6 percent nominal arithmetic net return).

[7]Our analysis for strategy 5 projects a small—0.1 percent or less—likelihood of 1 or more years with zero disbursement in the third and fourth decades of trust fund disbursements for each country.

Figures 11 through 16 compare projected compact trust fund disbursements and fund balances in the baseline scenario with projected disbursements and fund balances for the five selected potential strategies for improving the trust funds' outlook.

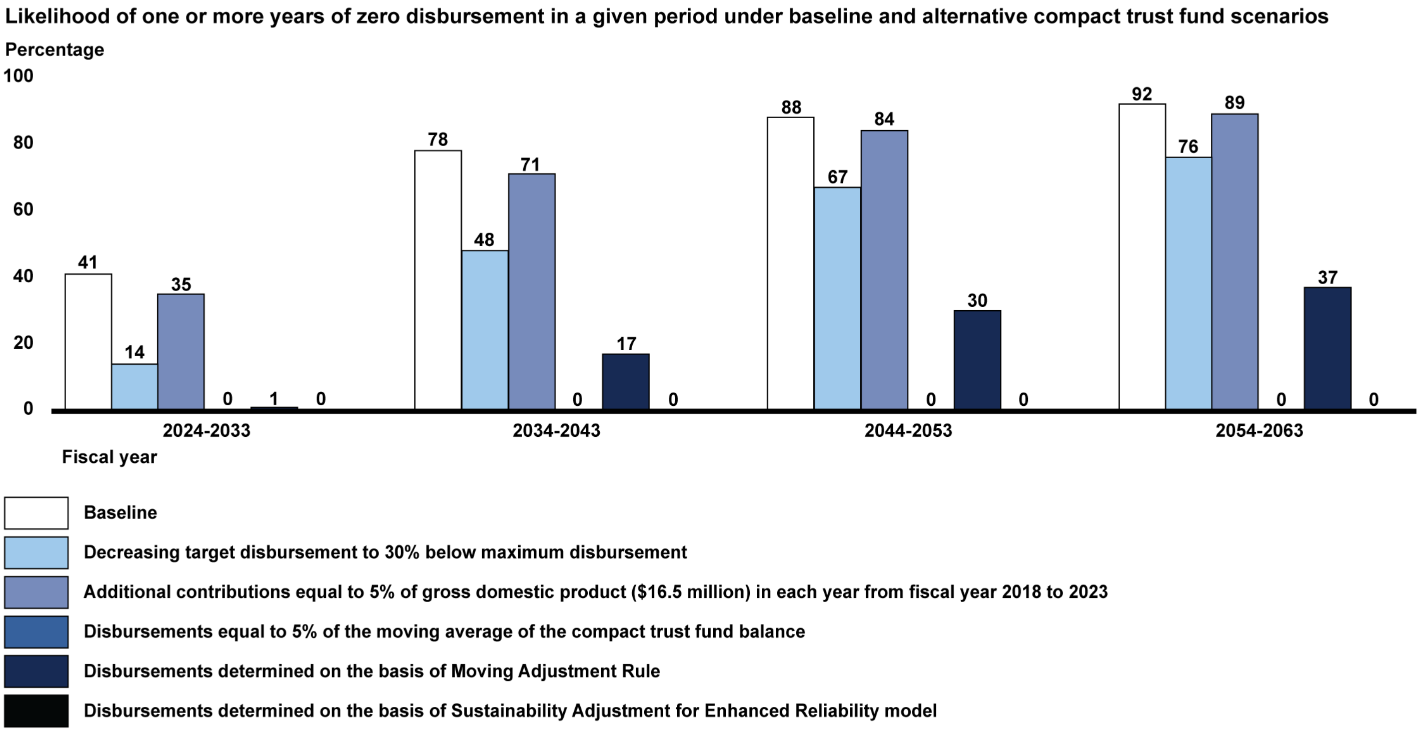
Figure 11: FSM Compact Trust Fund Projected Average Disbursement for Baseline Scenario and Selected Potential Strategies, Fiscal Years 2024-2063



Source: GAO analysis of Federated States of Micronesia (FSM) compact trust fund documents. | GAO-18-415

Note: We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent, for the baseline scenario and the potential strategies.

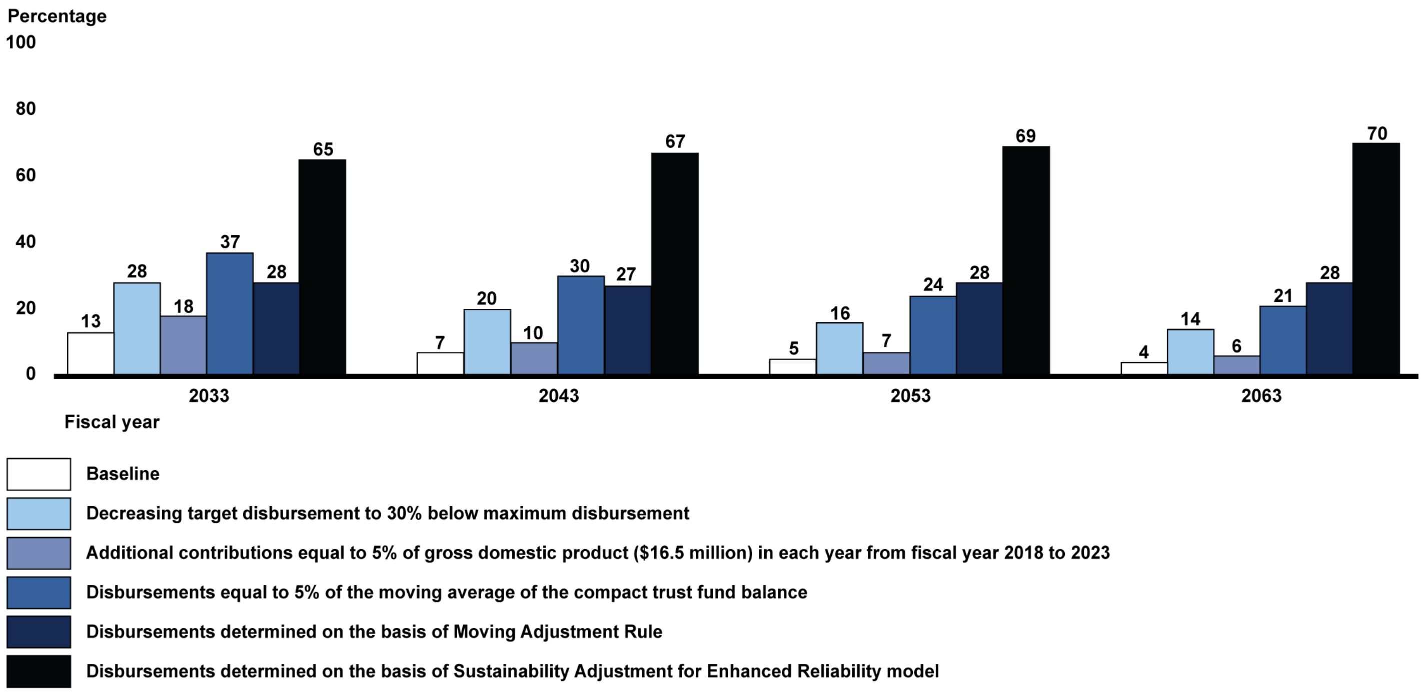
Figure 12: FSM Compact Trust Fund Projected Likelihood of Zero Disbursements for Baseline Scenario and Selected Potential Strategies, Fiscal Years 2024-2063



Source: GAO analysis of Federated States of Micronesia (FSM) compact trust fund documents. | GAO-18-415

Note: We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent, for the baseline scenario and the potential strategies.

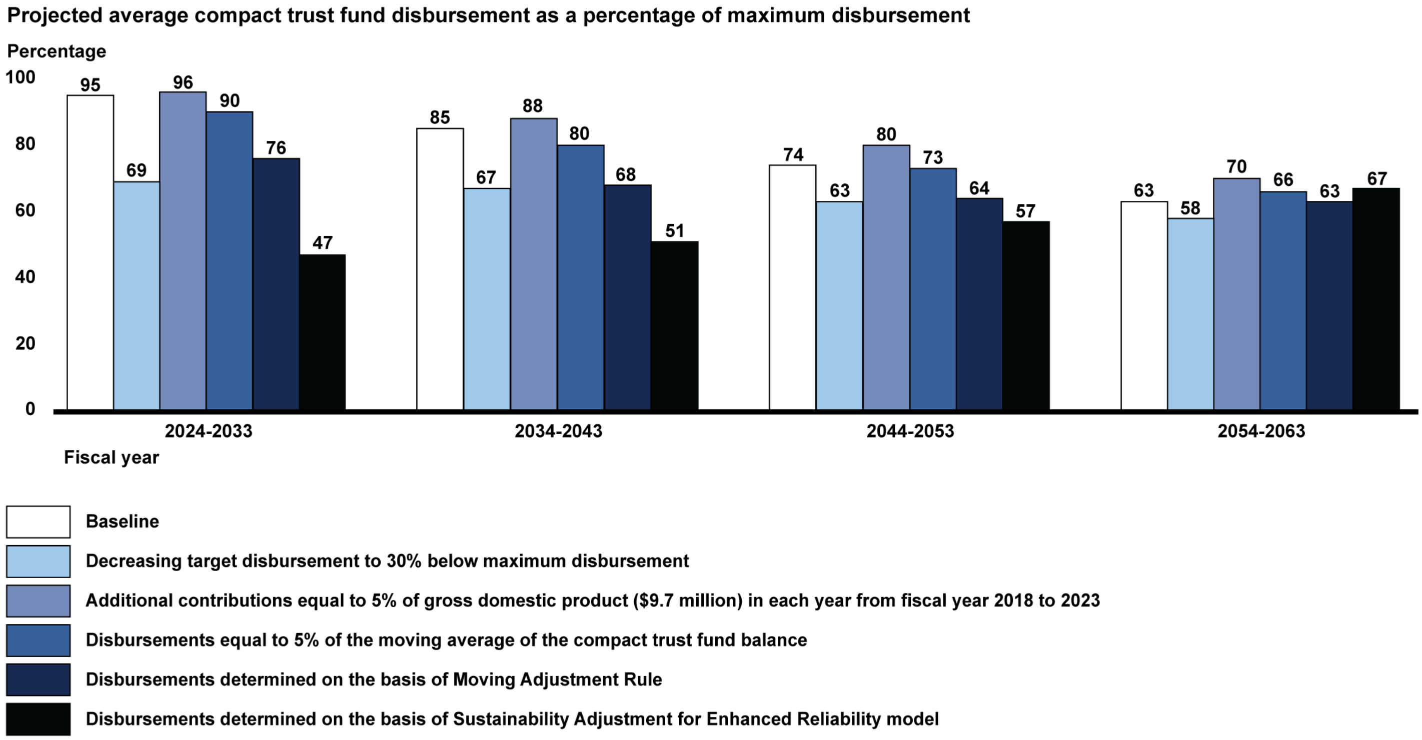
Figure 13: Likelihood of FSM Compact Trust Fund Balance Exceeding or Equaling the Inflation-Adjusted Fiscal Year 2023 Balance for Baseline Scenario and Selected Potential Strategies



Source: GAO analysis of Federated States of Micronesia (FSM) compact trust fund documents. | GAO-18-415

Note: We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent, for the baseline scenario and the potential strategies.

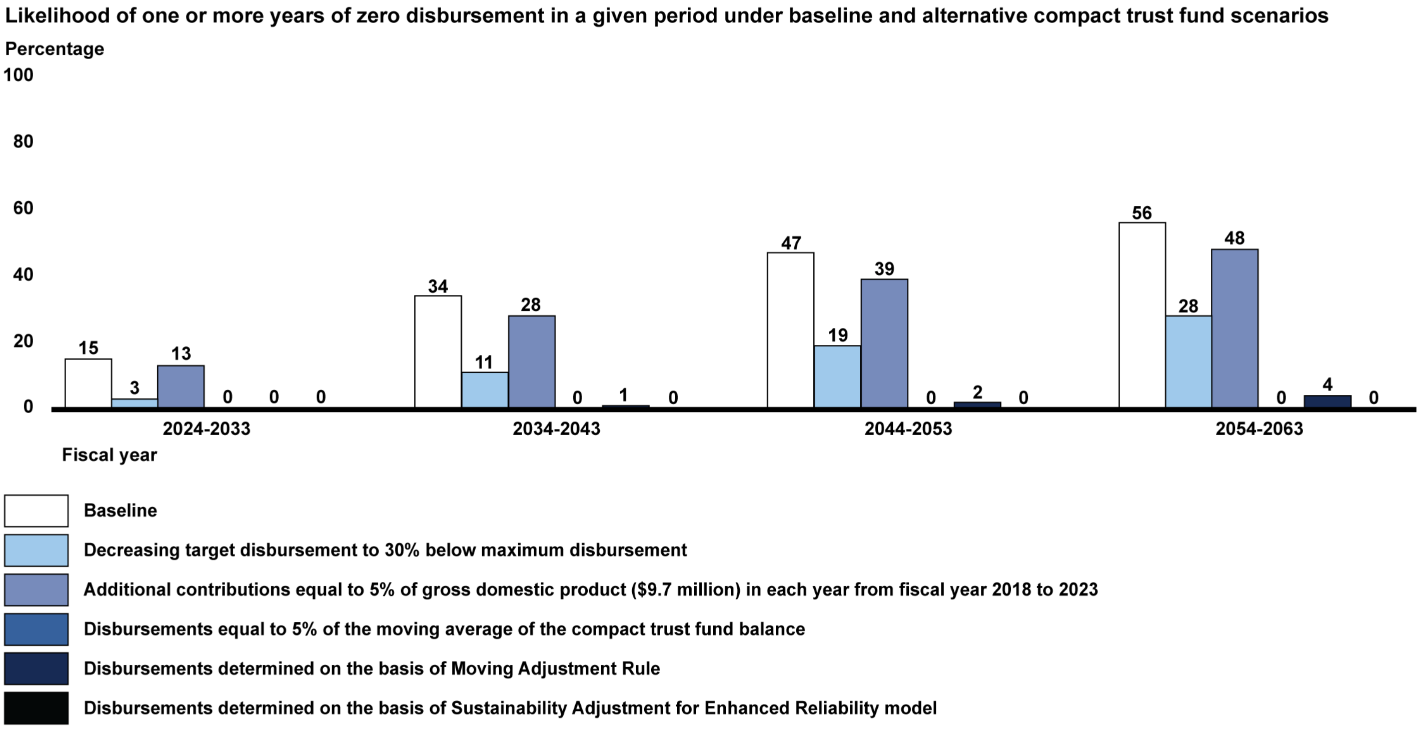
Figure 14: RMI Compact Trust Fund Projected Average Disbursement for Baseline Scenario and Selected Potential Strategies, by Decade, Fiscal Years 2024-2063



Source: GAO analysis of Republic of the Marshall Islands (RMI) compact trust fund documents. | GAO-18-415

Note: We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent, for the baseline scenario and the potential strategies.

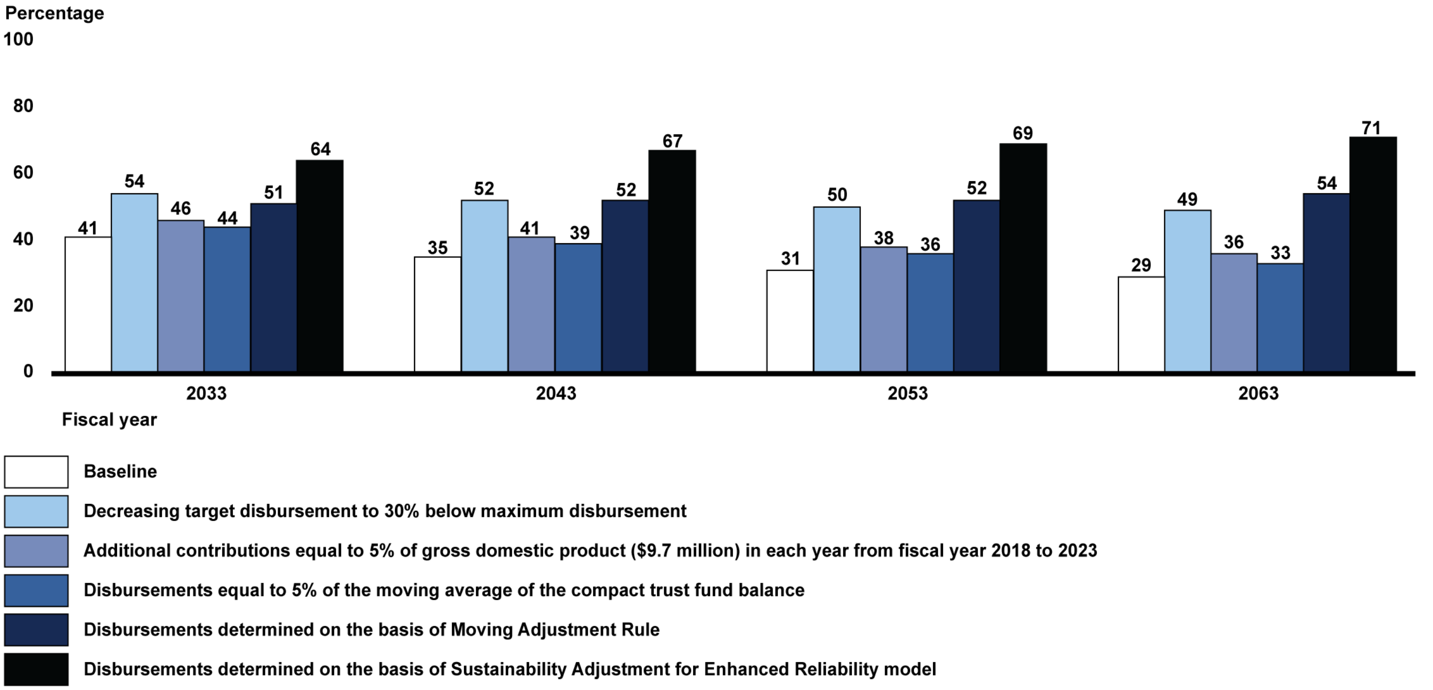
Figure 15: RMI Compact Trust Fund Projected Likelihood of Zero Disbursements for Baseline Scenario and Selected Potential Strategies, by Decade, Fiscal Years 2024-2063



Source: GAO analysis of Republic of the Marshall Islands (RMI) compact trust fund documents. | GAO-18-415

Note: We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent, for the baseline scenario and the potential strategies.

Figure 16: Likelihood of RMI Compact Trust Fund Balance Exceeding or Equaling the Inflation-Adjusted Fiscal Year 2023 Balance for Baseline Scenario and Selected Potential Strategies



Source: GAO analysis of Republic of the Marshall Islands (RMI) compact trust fund documents. | GAO-18-415

Note: We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent, for the baseline scenario and the potential strategies.

The amounts of disbursement reductions and additional contributions varied among the strategies examined in prior studies. To provide additional information about potential trust fund outcomes, we analyzed another four examples of the selected strategies that assumed a lower amount of additional trust fund contributions, lower disbursement reductions, or a lower percentage of the compact trust fund balance that could be withdrawn. Tables 13 and 14 show the results for all 9 analyses.

Table 13: Federated States of Micronesia (FSM) Compact Trust Fund Summary Table of Projected Average Disbursements, Likelihood of Zero Disbursements, and Likelihood of Maintaining Fund Balance under Baseline and Selected Potential Strategies

	Projected average compact trust fund disbursement (dollars in millions)				Projected average compact trust fund disbursement as a percentage of maximum disbursement				Percentage likelihood of 1 or more years with zero disbursement in a given 10-year period				Percentage likelihood of trust fund balance maintaining or exceeding inflation-adjusted fiscal year 2023 value			
	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY33	FY43	FY53	FY63
Baseline	75	54	44	36	82	49	33	22	41	78	88	92	13	7	5	4
Potential strategy																
Reduced annual trust fund disbursements, no change to compact trust fund agreement																
Decreasing target disbursement to 15% below maximum disbursement	69	56	48	41	76	50	35	25	27	66	80	87	19	12	9	7
Decreasing target disbursement to 30% below maximum disbursement	60	56	51	46	66	51	37	28	14	48	67	76	28	20	16	14
Additional trust fund contributions, no change to compact trust fund agreement																
Additional contributions equal to 2% of gross domestic product ($6.6 million) in each year from fiscal year 2018 to 2023	76	58	48	40	84	53	36	24	38	75	87	91	15	8	6	5
Additional contributions equal to 5% of gross domestic product ($16.5 million) in each year from fiscal year 2018 to 2023	78	63	53	45	86	57	39	27	35	71	84	89	18	10	7	6

	Projected average compact trust fund disbursement (dollars in millions)				Projected average compact trust fund disbursement as a percentage of maximum disbursement				Percentage likelihood of 1 or more years with zero disbursement in a given 10-year period				Percentage likelihood of trust fund balance maintaining or exceeding inflation-adjusted fiscal year 2023 value			
	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY33	FY43	FY53	FY63
Changed disbursement policies (disbursing from the A account)																
Disbursements equal to 3% of the 3-year moving average of the compact trust fund balance	34	46	59	74	37	41	43	45	0	0	0	0	57	55	54	54
Disbursements equal to 4% of the 3-year moving average of the compact trust fund balance	44	52	61	72	48	47	45	43	0	0	0	0	46	41	38	36
Disbursements equal to 5% of the 3-year moving average of the compact trust fund balance	52	56	60	65	57	50	44	40	0	0	0	0	37	30	24	21
Moving Adjustment Rule (MAR)	62	45	38	40	68	41	28	24	1	17	30	37	28	27	28	28
Sustainability Adjustment for Enhanced Reliability (SAFER)	23	30	41	58	25	27	30	35	0	0	0	0	65	67	69	70

Legend: FY = fiscal year

Source: GAO analysis of compact trust fund documents. | GAO-18-415

Notes: We used the compact trust fund's unaudited balance at the end of fiscal year 2017 as the starting balance. We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent.

We calculated the average disbursement in the given time periods by averaging 10-year period simulated disbursements (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging the ratio of simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given time period (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement among the 10,000 simulated cases in each given time period.

We calculated the likelihood of the fund balance maintaining its inflation-adjusted fiscal year 2023 value by simulating 10,000 cases and counting those in which the simulated balance does not equal or exceed the projected inflation-adjusted 2023 balance

Table 14: Republic of the Marshall Islands (RMI) Compact Trust Fund Summary Table of Projected Average Disbursements, Likelihood of Zero Disbursements, and Likelihood of Maintaining Fund Balance under Baseline and Selected Potential Strategies

	Projected average compact trust fund disbursement (dollars in millions)				Projected average compact trust fund disbursement as a percentage of maximum disbursement				Percentage likelihood of 1 or more years with zero disbursement in a given 10-year period				Percentage likelihood of trust fund balance maintaining or exceeding inflation-adjusted fiscal year 2023 value			
	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY33	FY43	FY53	FY63
Baseline	28	31	33	34	95	85	74	63	15	34	47	56	41	35	31	29
Potential strategy																
Reduced annual trust fund disbursements, no change to compact trust fund agreement																
Decreasing target disbursement to 15% below maximum disbursement	25	28	31	34	83	77	70	62	8	22	32	43	47	43	41	39
Decreasing target disbursement to 30% below maximum disbursement	21	24	28	31	69	67	63	58	3	11	19	28	54	52	50	49
Additional trust fund contributions, no change to compact trust fund agreement																
Additional contributions equal to 2% of gross domestic product ($3.9 million) in each year from fiscal year 2018 to 2023	29	32	34	36	96	87	77	66	14	31	43	54	42	37	34	32
Additional contributions equal to 5% of gross domestic product ($9.7 million) in each year from fiscal year 2018 to 2023	29	32	36	38	96	88	80	70	13	28	39	48	46	41	38	36

	Projected average compact trust fund disbursement (dollars in millions)				Projected average compact trust fund disbursement as a percentage of maximum disbursement				Percentage likelihood of 1 or more years with zero disbursement in a given 10-year period				Percentage likelihood of trust fund balance maintaining or exceeding inflation-adjusted fiscal year 2023 value			
	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY24-FY33	FY34-FY43	FY44-FY53	FY54-FY63	FY33	FY43	FY53	FY63
Changed disbursement policies (disbursing from the A account)																
Disbursements equal to 3% of the 3-year moving average of the compact trust fund balance	21	26	31	38	70	70	70	69	0	0	0	0	57	57	57	58
Disbursements equal to 4% of the 3-year moving average of the compact trust fund balance	25	28	32	37	83	76	72	68	0	0	0	0	48	45	44	42
Disbursements equal to 5% of the 3-year moving average of the compact trust fund balance	27	29	32	36	90	80	73	66	0	0	0	0	44	39	36	33
Moving Adjustment Rule (MAR)	23	25	29	34	76	68	64	63	0	1	2	4	51	52	52	54
Sustainability Adjustment for Enhanced Reliability (SAFER)	14	19	26	37	47	51	57	67	0	0	0	0	64	67	69	71

Legend: FY = fiscal year

Source: GAO analysis of compact trust fund documents. | GAO-18-415

Notes: We used the compact trust fund's unaudited balance at the end of fiscal year 2017 as the starting balance. We assumed that the trust fund's annual return will have a normal distribution and a 6 percent nominal return net of fees, with a standard deviation of 13 percent.

We calculated the average disbursement in the given time periods by averaging 10-year period simulated disbursements (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the average disbursement as a percentage of the maximum allowable disbursement by averaging the ratio of simulated disbursement to the maximum inflation-adjusted allowable disbursement in the given time period (averaging first over 10 years and then over 10,000 simulated cases).

We calculated the likelihood of zero disbursement by counting cases with 1 or more years of zero disbursement among the 10,000 simulated cases in each given time period.

We calculated the likelihood of the fund balance maintaining its inflation-adjusted fiscal year 2023 value by simulating 10,000 cases and counting those in which the simulated balance does not equal or exceed the projected inflation-adjusted 2023 balance.

Appendix VIII: Status of Other Planned Actions in the FSM and RMI Decrement Management Plans

In addition to planning budget reductions in the FSM Long-Term Fiscal Framework (its decrement management plan) and the RMI Decrement Management Plan, the FSM and RMI planned other actions such as tax reforms and subsidy reductions to address the scheduled decrement in compact sector grants. The FSM implemented two of three planned actions and the RMI implemented one of four planned actions. The FSM did not implement unified tax reform measures but implemented a change in the formula for sharing compact sector grants with the FSM states and using planned surpluses to mitigate the effects of fiscal reforms. The RMI did not implement planned new taxes, reductions in subsidies to state-owned enterprises, or reductions in payments to Majuro landowners for the use of their land for utilities. The RMI did program a portion of its fishing fee surplus into the annual budget.

FSM

As of January 2018, the FSM national government had implemented two of three actions that the FSM Long-Term Fiscal Framework indicated the FSM would take in addition to budget reductions.

1. Implementing unified tax reform measures
   - *Not implemented.* The FSM Long-Term Fiscal Framework states that substantial effort and progress has been made towards comprehensive tax and revenue reform and that the FSM national and state governments anticipated that the Long-Term Fiscal Framework process would provide further impetus towards tax reform. However, according to FSM officials, two FSM states (Pohnpei and Yap) did not approve the Unified Revenue Act. According to FSM officials, the FSM is currently considering other models for tax reform and plans to revisit the issue in the future.
2. Reducing the national government’s share of compact grants and reallocating it to the FSM states
   - *Implemented.* According to the Long-Term Fiscal Framework, FSM Public Law 18-12 reduced the national government’s share of fiscal year 2014 compact grants from 10 percent to 5 percent, with the amount of the reduction passed along to the FSM states. In May 2014, FSM Public Law 18-57 further reduced the national government’s share of compact grants to 0 percent and increased the amount of compact grants allocated to the state governments, according to the FSM.

3. Using planned surpluses for actions such as possible contributions to activities that mitigate the effects of fiscal reforms, the FSM's compact trust fund, retiring debt, or reform costs.
    - *Implemented.* The FSM national government has made additional trust fund contributions but, according to FSM officials, has made a policy decision to make these contributions to the FSM Trust Fund instead of the compact trust fund.

RMI

As of January 2018, the RMI national government had implemented one of four other actions that its decrement management plan indicated it would take.

1. Implementing a value-added tax and net profits tax in 2017
    - *Not implemented.* Officials from the RMI Economic Policy, Planning, and Statistics Office and Ministry of Foreign Affairs confirmed that tax reform has not been implemented due to political challenges. However, a tax task force has been established to revisit tax revenue reforms.
2. Programming 80 percent of unallocated Marshall Islands Marine Resources Authority fishing fee surplus into the annual budget in fiscal year 2015 and using the remaining 20 percent to develop the fishing industry.
    - *Implemented.* The RMI programmed a portion of its fishing fees into the annual budget in fiscal years 2015 through 2017—$15.8 million in fiscal year 2015, $26.3 million in fiscal year 2016, and $40 million in fiscal year 2017. Although fishing fees were programmed into the budget, according to RMI's Office of Compact Implementation, the formula allocating 80 percent of fishing fee revenue into the annual budget and the remaining 20 percent to develop the fishing industry is part of proposed RMI legislation but has not become law.
3. Reducing state-owned enterprise subsidies by 10 percent in fiscal years 2016 and 2018.
    - *Not implemented.* The RMI national government did not reduce the total amount of state-owned enterprise subsidies by 10 percent in fiscal years 2016 as committed in the 2014 decrement management plan. Audit reports for state-owned enterprises in fiscal years 2015 and 2016 indicate that, while the RMI reduced subsidy amounts for some state-owned enterprises, other subsidy

amounts increased and overall subsidies were higher in both fiscal years 2015 and 2016 than in fiscal year 2014.[1] See table 15.

Table 15: RMI State-Owned Enterprise Subsidy Amounts, Fiscal Years 2014-2016

Fiscal year	Total subsidy amounts	Difference from fiscal year 2014
2014	$9,176,149	–
2015	$15,299,863	$6,123,714
2016	$13,022,163	$3,846,014

Legend: – = not applicable

Source: GAO analysis of RMI state-owned enterprise audit reports, fiscal years 2014-2016. | GAO-18-415

4. Reducing government transfers to Majuro landowners to compensate for the government's use of their land for utilities by 20 percent in fiscal years 2016, 2018, and 2021.
   - *Not implemented.* The RMI national government has not reduced government transfers to Majuro landowners to compensate for the government's use of their land for utilities due to political challenges, according to RMI officials. RMI Ministry of Finance officials stated that, as of January 2018, there had been no reductions in government transfers to Majuro landowners. According to RMI government officials, the total rent payment bill has in fact increased as utilities in Majuro have expanded.

[1]As of March 2018, audit reports for fiscal years 2017 and 2018 were not yet available.

Appendix IX: Comments from the Department of the Interior

United States Department of the Interior

OFFICE OF THE SECRETARY
Washington, DC 20240

APR 18 2018

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

Dear Director Gootnick:

Thank you for providing the Department of the Interior (Department) the opportunity to review and comment on the draft Government Accountability Office (GAO) report entitled, *COMPACTS OF FREE ASSOCIATION: Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income* (GAO-18-415). We appreciate GAO's review of issues related to the transition of the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) from sector-grant assistance under the Compact of Free Association, as amended, to income from the Trust Funds which the amended compact has provided.

The Department concurs with the GAO recommendations that the Trust Fund Committees complete the requirements of the Trust Fund Agreements: (1) develop a distribution policy for the FSM/RMI; (2) develop the fiscal procedures for disbursements from the Trust Funds; and (3) address the timing of the calculation of income derived from the Trust Funds. The draft report along with independent studies completed by the Asian Development Bank, the World Bank, Arthur J. Gallagher & Company, Funston Advisory Services LLC, and the Graduate School, USA, all provide options that will assist the respective Trust Fund Committees to complete the three requirements.

Discussions are ongoing within the Trust Fund Committees to complete the three requirements identified above with the underlying objective that the Trust Funds exist indefinitely as an annual source of revenue for the FSM and RMI. Additionally, a working group of staff from the Department's Office of Insular Affairs (OIA) and the Department of State's Office of Australia, New Zealand and Pacific Island Affairs will present recommendations related to the three requirements to the Trust Fund Committees in 2018. From the recommendations, the Trust Fund Committees will, as authorized, be able to undertake actions required by the Trust Fund Agreements. Additional actions may involve discussions with the original parties of the Trust Fund Agreements and legislation through the U. S. Congress.

If you have any questions or need additional information, please communicate with me at (202) 208-4736 or email Nikolao_Pula@ios.doi.gov. Alternately, you or your staff may wish to communicate with Joseph McDermott, OIA's Policy Desk Officer for the Trust Funds, at (202) 219-0037 or Joseph_McDermott@ios.doi.gov.

Sincerely,

Nikolao Pula

Nikolao Pula
Director
Office of Insular Affairs

Appendix X: Comments from the U.S. Postal Service

FRANCA DAVIS
MANAGING DIRECTOR, GLOBAL BUSINESS

UNITED STATES POSTAL SERVICE

April 3, 2018

David Gootnick
Director, International Affairs and Trade
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Mr. Gootnick:

This letter serves as the Postal Service's management response to draft General Accountability Report (GAO) report, GAO-18-415, *Compacts of Free Association: Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income*. Although, in general, it appears that the draft report includes helpful information on the Compact obligations regarding postal services provided to the Freely Associated States ("FAS"), and their impact on the FAS and the Postal Service, we believe that it is important to supplement the GAO's findings with additional information concerning the financial losses incurred by the Postal Service in connection with its provision of service to the FAS pursuant to the Compacts. Footnote b on page 61 of the report includes information regarding annual shortfalls experienced by the Postal Service in Fiscal Years 2015 and 2016, but by omitting shortfall information since 2002, the report, in its current form, understates the substantial losses and burdens experienced by the Postal Service due to the unreimbursed costs of providing services to the FAS under the Compacts.

Now on page 68.

As background, although the Compacts authorize reimbursement for the postal services provided to the FAS, because of the budgetary structure utilized for reimbursement, the reimbursement amount received by the Postal Service has fallen short of the costs of service to the FAS. While the Postal Service pays for all transportation costs of FAS mail to and from the FAS, because each FAS Postal Administration currently retains the revenue it receives from postage sales, and the Postal Service is able to generate revenue only from services for shipments originating in the U.S. for delivery to the FAS, the Postal Service is limited in its ability to recoup the costs of service to the FAS. As reflected in the table below, during the period between 2002 and the present, the Postal Service has suffered a total shortfall of almost $70 million.

REIMBURSEMENT SHORTFALL[1]

Year	Billed	Received	Difference
2002	$3,849,606.77	$2,000,000.00	($1,849,606.77)
2003	$3,922,284.87	$1,200,000.00	($2,722,284.87)
2004	$3,126,104.22	$2,259,720.24	($866,383.98)
2005	$2,529,434.57	$2,431,512.00	($97,922.57)
2006	$3,175,705.80	$2,300,000.00	($875,705.80)
2007	$2,846,169.99	$2,000,000.00	($846,169.99)
2008	$3,894,313.52	$2,000,000.00	($1,894,313.52)
2009	$5,656,364.42	$4,000,000.00	($1,656,364.42)
2010	$8,913,602.53	$2,000,000.00	($6,913,602.53)
2011	$8,787,110.29	$2,200,000.00	($6,587,110.29)

[1] Source: International Accounting Branch, United States Postal Service's Billing Determinants

475 L'ENFANT PLAZA SW
WASHINGTON DC 20260
202-268-5931
USPS.COM

2012	$10,031,040.63	$2,500,000.00	($7,531,040.63)
2013	$7,737,716.47	$3,259,193.00	($4,478,523.47)
2014	$9,638,803.74	$2,314,000.00	($7,324,803.74)
2015	$10,681,623.66	$2,255,500.00	($8,426,123.66)
2016	$11,324,936.67	$2,267,808.19	($9,057,128.48)
2017*	$11,039,456.05	$2,250,000.00	($8,789,456.05)

*** Denotes Preliminary Estimate**
TOTAL ($69,916,540.77)

As we move forward, the expenses for this service are expected to continue to increase significantly due to the increase in air transportation costs. Although recently President Trump signed legislation that could provide additional funding to the Postal Service for postal services provided to Palau, as of yet there has been no commitment of this funding for reimbursement of Postal Service costs incurred in previous years.

When the Federal Programs and Services Agreement of the Compacts of Free Association with the Republic of Marshall Islands ("RMI") and the Federated States of Micronesia ("FSM") expire, the Postal Service recommends that all provisions found in Article VI of the Federal Programs and Service Agreement to the Compact Agreements cease, and that the RMI and FSM be treated as international origin and destination points.

Thank you for your consideration of our comments, and please contact us if further discussion would be helpful.

Franca S. Davis

Franca S. Davis
Managing Director, Global Business

Appendix XI: Comments from the Federated States of Micronesia

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

EMBASSY OF THE
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April 23, 2018

Mr. David Gootnick
Director International Affairs and Trade
U.S. Government Accountability Office
441 G St. NW
Washington D.C. 20548

Dar Mr. Gootnick,

I am pleased to submit herewith the comments prepared by the Government of the Federated States of Micronesia relative to GAO's Report on the transition of FSM to the Trust Fund Income.

It is our hope that the GAO will consider our comments favorably as it prepares the final draft of this Report. We look forward to the opportunity to appear before the appropriate entities of the U.S. Government to further clarify our comments, concerns, and the general overview of the implementation of the amended Compact of Free Association with the United States.

Thank you for your kind assistance in this matter.

Sincerely,

Akillino H. Susaia
Ambassador
Embassy of the Federated States of Micronesia
1725 N St. NW
Washington D.C. 20036

Actions Needed to Prepare for the Transition of FSM to Trust Fund Income – FSM Comments on GAO Report

Preface

About three thousand years ago, the Federated States of Micronesia (FSM) region was settled by explorers who ultimately chose to make the islands their homes. As memorialized in the Preamble of the FSM Constitution: “Our ancestors, who made their homes on these islands, displaced no other people.”

European explorers reached the Caroline Islands (FSM) in the 16th century, with Spain establishing sovereign authority over the islands. Spain sold the islands to Germany in 1899, which administered the islands until 1920 when Japan took over the islands from Germany under a mandate from the League of Nations.

From 1947 to 1986 (about 40 years), the United States of America (US) administered the region under a United Nations trusteeship to assist Micronesia (FSM, Palau, Republic of the Marshall Islands, and CNMI) to promote economic advancement and social improvements. On May 10, 1979, FSM became a constitutional government pending the termination of the Trusteeship.

On November 3, 1986, the Trusteeship was terminated and FSM became a sovereign independent country with free association with the US through the Compact of Free Association, a treaty between FSM and US with the overall goals of: a) ensuring certain national security rights of the parties, and b) economic development and budgetary self-reliance of the FSM through US direct financial assistance.

During the Trust Territory era (1947 – 1986) as well as throughout the first period of the original Compact of Free Association between the US Government and the Government of the FSM (1986 – 2003), funding was made available by the Government of the United States to the Government of the Federated States of Micronesia for general government operations, capital projects and other government services.

In 2003, an amended Compact came into effect authorizing additional financial assistance to the FSM for a 20-year period. The funding assistance provisions of Title II of the amended Compact will terminate in 2023, after which a Compact Trust Fund is envisioned to provide the FSM with an ongoing source of revenue after 2023 to help fund operational needs of the FSM Government. This arrangement, like the Title II assistance, is in consideration of the special relationship between the Government of the United States and the Government of the Federated States of Micronesia.

The GAO draft report outlining actions needed to prepare for the transition of Micronesia and the Marshall Islands to Trust Fund Income is most welcome and appreciated by the Government of the Federated States of Micronesia. It is timely in view of the approaching termination of the economic assistance provisions of the Compact of Free Association and the need for the Government of the United States and the Government of the Federated States of Micronesia to assess the benefits derived respectively under the amended compact and other considerations.

The Government of the Federated States of Micronesia appreciates the impartiality of the report and commends the report drafters for their diligence and professionalism. The FSM, in full consideration of the special relationship between the Government of the United States and the Government of the Federated States of Micronesia and their peoples, acknowledges the need to undertake whatever steps may be necessary to prepare as we can for FSM budgetary self-reliance beginning in 2024.

The FSM Government offers the following comments on the draft report. We suggest that historical perspectives are fully considered to inform the preparations of the transition to Trust Fund Assistance as envisioned under the amended compact.

(1) Federal Funds & Programs

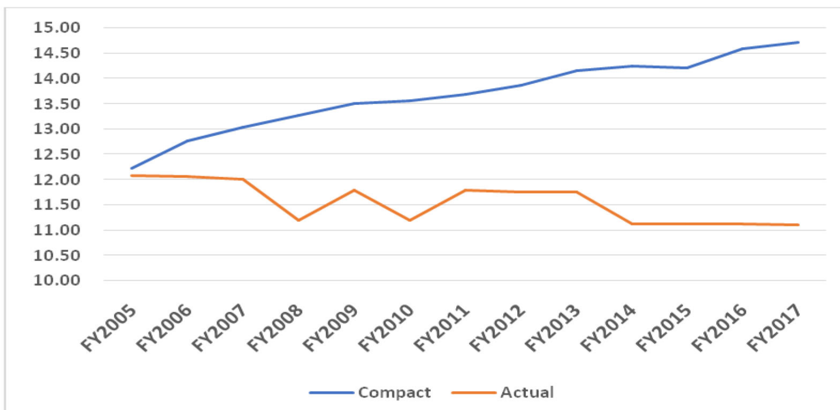
As noted in the GAO Report, the FSM receives a number of programs and services from a wide variety of US Federal agencies apart from the Interior Department. These sources of support are essential to the FSM and should continue to the greatest extent possible post 2023. The FSM appreciates the efforts of the GAO to identify those programs and services which will be eligible post 2023. The FSM wishes to engage in consultations with US agencies across the board in a coordinated way to discuss all of these programs, with a focus on identifying those for which actions may need to be taken to continue eligibility.

Where US Congressional reauthorization is likely to be required to continue programs and services in the FSM after 2023, the FSM would like to work with US officials to ensure this approval can be obtained in a timely manner. FSM recognizes that discussions with some US agencies will be required and is concerned about any program or service that may be ending. The impact of this may be severe on some education programs such as early childhood education.

The Amended Compact provides financial assistance to FSM Education Sector annually. In addition, supplemental education grants are made available to the four states, COM-FSM, and National Department of Education to operate early childhood education, adult education, and workforce skill training, provide for college work study program (COM-FSM), and three initiatives at the national department of education to improve teacher qualification, school accreditation, and data management information system.

The Amended Compact states for the Supplemental Education Grant (SEG) that the grant will be $12,230,000 in FY2005 and it will be adjusted upward each year thereafter using the partial inflation (2/3 US GDP deflator) up to 2023. Figure 1 below graphs FSM expectations as set out in Amended Compact against the actual grant provided. As can be seen FSM received considerably less SEG than it could have anticipated each year, and accumulatively, up to FY2017, this was $27.7 million less that it had expected at the time it signed the Amended Compact. This is a significant gap in education financing and underlines the need for continued assistance in this area post 2023, with changes in the US law as needed.

Figure 1: Supplemental Education Grant ($ million)



It is the FSM's understanding that all Federal health grants will continue to be available post 2023.

The FSM is very concerned of what is transpiring with public sector capacity building, private sector development and environment sectors as a result of a JEMCO resolution in 2006. When the FSM negotiated the Amended Compact it was not of the understanding that these sector grants would be limited to project based grant submissions. The impact of recent pressure in this area is an accumulation of unallocated grant money. The Private sector development grant has been relatively unsuccessful as shown in the economic growth figures for FSM since 2004 with average annual growth at -0.5 percent.

Capacity building has been limited under the Amended Compact. Graduate School technical assistance for the Statistics Office has been disappointing in the area of national accounts. The process of consultants flying in and collecting data, then flying out to Palau to calculate the national accounts series is not acceptable and stronger focus should be placed on in-country capacity building.

In the case of the Chuuk Financial Control Commission (CFCC) the key issue identified in the Preliminary Review carried out by the Graduate School in 2011 was that no capacity building is being undertaken. They recommended a change to the way CFCC operates but unfortunately JEMCO did not act on this Report. This is of considerable concern as to what happens in Chuuk in FY2024.

One of the issues that concerns the FSM is that when JEMCO fails to allocate the full available grant each year it creates a carry-over grant for subsequent years. At times this carryover for operational grant has exceeded $20 million and as JEMCO insists that this money can only be used for project-based proposals the FSM education and health sector officials invariably looks to infrastructure and maintenance projects to utilize these funds.

A critical issue facing the commercial-banking sector and financial stability of FSM is the possible loss in financial services provided by the FDIC. To reduce exposure to money laundering and to reduce noncompliance with regulatory authorities, global banks are reducing correspondent banking services to third-country banks. We wish to continue the availability of FDIC assistance.

The FSM will move forward to discussing with the United States continuing assistance from the US Postal Service and Federal Aviation Administration, along with other essential programs and services.

The way FEMA grants will be distributed post 2023 will see FSM in the same situation as other Pacific Island countries and without the immediate and full support the FSM may have to consider other disaster funds as its primary focus.

(2) Compact Trust Fund Committee

Although the Compact Trust Fund Committee has not established its distribution policy, considerable work has been undertaken in the last 18 months on the different modelling scenarios to inform the Committee on possible distribution scenarios.

All studies have noted the Trust Fund is under-funded and there is a high possibility of negative returns in any year and volatility around disbursement. In fact, the GAO representative Ms Westin, at the Congress Public Hearing in Washington July 17, 2002 on the proposed Amended Compacts, stated:

See comment 1.

"As I previously mentioned, the US proposals are designed to build trust funds that earn a rate of return such that trust fund yields can replace grant funding. We analyzed the trust funds proposals to determine if the trust fund yields would replace grant funding as intended, assuming a 6 percent rate of return.

According to our analysis, the US proposal to the RMI would meet its goal while the US proposal to FSM would not. Moreover, at 6 percent, the US proposal to RMI would cover the estimated value of expiring Federal services while the US proposal to the FSM clearly would not. At a 6 percent rate of return, neither proposed trust fund would generate surplus funds to serve as a buffer against years of low or negative trust fund yields."

Thus, the issues for the FSM Compact Trust Fund have been on the table from the beginning, noted in the US Congress hearing, but to date little has been done to address the expected shortfall.

The current distribution options considered by GAO have also been considered by the Committee but a key at this stage is for FSM to look at a bottom up approach and how the distribution may be allocated among sectors. The FSM would be opposed to retaining the 30 percent infrastructure allocation (as is the current practice on sector grants) in the medium term as based on current information FSM will still be undertaking the implementation of a large proportion of grant arrears for at least another 5 years after 2023.

In mid-2004 the National and State governments pooled their resources in order to come up with the initial $30 million FSM contribution to the startup of the Compact Trust Fund. In fact, the FSM was short and it was only through the ability to utilize another donor's funds of $2.5 million that the FSM was able to meet the $30 million target.

However, the downside of this deposit was it significantly reduced the reserves of the State Governments and their ability to finance deficits as a result of cut-backs in grant funding was diminished. Only Yap State has been able to maintain its reserve levels over the Amended Compact period.

Subsequent to the first injection from another donor when FSM has approached donors to contribute to the Compact Trust Fund the answer has always been negative whereas they are willing and have contributed to the FSM's domestic Trust Fund. Donors see the Compact Trust Fund as belonging to, under the control of, and the responsibility of, the US government, and therefore have been unwilling to make contributions to it.

Now on page 34.

Note 56 on page 30 refers to the issue around the fact that the current FSM internal distribution formula refers to Compact grants and may not necessarily be used for Trust Fund disbursements. The FSM is aware of this issue and will ensure that this is considered by the FSM Congress in due course. More importantly, the Trust Fund distribution policy will inform the recommendation to the FSM Congress.

(3) Planning for 2023

In Appendix II, Figure 9 shows the Compact grant and trust fund contributions prior to the partial inflation adjustment. It should be noted that although the decrement reduces the amount of the grant on an annual basis this is generally been offset by the partial inflation adjustment and therefore the overall level of grant availability to the FSM does not decline.

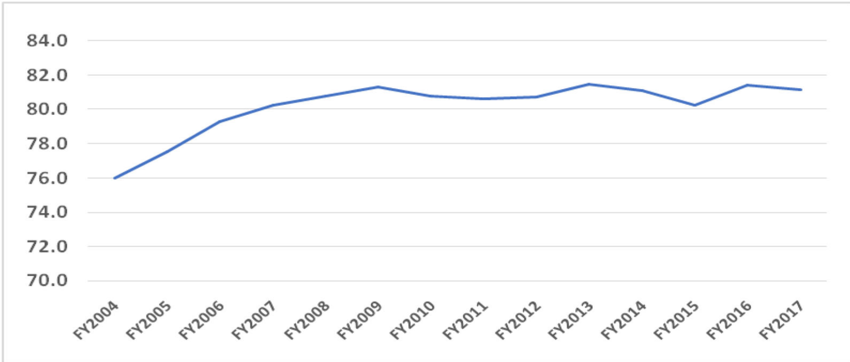
See comment 2.

Figure 2 below provides the annual grant available to the FSM. As can be seen, the annual decrement is offset by the inflation rate in most years and thus there has been minimal fluctuation in the grant which has made the medium-term budget framework exercise easier to manage.

See comment 3.

One issue that the FSM wishes to raise is that at the time of the Amended Compact negotiation the FSM agreed to the decrement with the understanding that when this was deposited in the Trust Fund it would be recorded as FSM's annual contribution to the Fund. FSM sees itself as having been making annual contributions to the Trust Fund and these are now quite substantial as the decrement accumulates. FSM understands that at the instruction of the OIA the Fund Custodian is recording this as a US contribution. The FSM requests that this is rectified.

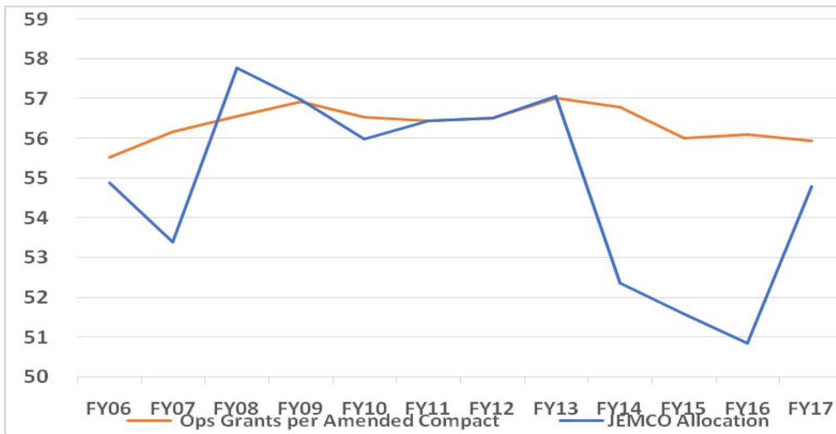
Figure 2: Annual Grant available to the FSM ($ million)



On the issue of the Long Term Fiscal Frameworks (LTTF's) the FSM had agreed to this exercise on the basis that it could be a useful tool if used correctly. However, during the process of the development of the LTFF's the purpose appeared to change. It is our understanding that the issue was to recognize that although the nominal value of the grant was not declining the real value was. Thus to maintain the real value of the key sectors, health and education, there needed to be a shift in other sectors away from Compact grants to allow for upwards adjustments in the health and education grants to maintain their value in real terms.

However, it turned out that the exercise became one of trying to force down FSM expenditures of its grants as it became clearer to the US that the Compact Trust Fund had a significant shortfall and so the States were instructed by the OIA advisors to reduce expenditure across all sectors. This resulted in a very stressful 3-year period (FY2014 – FY2016) for the State budgets and at the same time FSM accumulated unspent grants funds (refer figure 3 below).

Figure 3: Under-expenditure as a result of LTFF ($ million)



As the LTFF exercise was to be updated every 3 years the FSM used the FY 2017 budget to realign the revenue projections and bring grant allocation back in line with the available funds. The difference in the graph in FY 2017 is the under-allocation of the small sector grants which have been reducing each year (further discussed below).

Public Sector Reform

A key component of the Strategic Development Plan 2004 -2023 is the transformation of the economy to be private sector driven rather than being driven in response to the Government needs. History has taught us that this is most likely to be achieved by expanding the private sector rather than attempting to shrink the public sector. As noted above this structural change in the economy is taking place and should be encouraged.

However, there have been two main issues associated with the way public sector reform has been implemented:

1. The reduction in force of 2007 was poorly formulated and resulted in significant migration as there was not enough attention to the options for private sector participation in the two Sates which have relatively small private sectors. This resulted in out migration of FSM citizens to other job markets.
2. Public sector pay freezes were introduced at the National and State levels and as a result individuals pay levels have grown below the rate of inflation and this has meant

that the purchasing power of employees has declined over the amended Compact period to date. In fact, people are poorer than at the beginning of the amended Compact

The State and National governments have implemented programs to streamline administrations and reduce public expenditures where possible but that will not be enough to respond to the financial needs of the nation over the coming years due to the magnitude of the adjustments required over the long term.

An ongoing effort on administrative reform which began in 2014 with ADB technical assistance at the National Government has since been undertaken at Pohnpei State and is now in Yap State providing recommendations for reform. The National and Pohnpei State Governments are currently reviewing the recommendations for implementation.

Tax Reform

There are a number of compelling reasons for reforming the tax system in the FSM. As projected during the 3rd FSM Economic Summit, new funding levels and structure under the amended Compact would result in deteriorating economic and budgetary situations. The FSM needs to undertake tax reform for the following reasons:

- To address budgetary pressures and in some cases imbalances resulting from decreases and different structure of Compact funds;
- To better position the FSM economy to weather the adverse impacts of decreases in Compact funding by improving the tax regime to one that is more supportive of private investment and growth;
- To address inherent weaknesses in current tax administration; and,
- To position the tax system to be in compliance with Trade Liberalization Agreements FSM is party to.

A well-functioning tax system provides the means by which governments can fund the services expected of it and, in the case of less developed countries, achieve greater self-sufficiency by way of lower reliance on overseas provided budgetary support.

Important as it is, tax reform is nevertheless extremely difficult to bring into effect. A good tax system is difficult to implement and sustain because taxation is inherently intrusive affecting all aspects of a society and its economy. It impacts on income and wealth distribution and inter-reacts with all aspects of the economy. In addition, especially given the necessary focus on administering taxation systems through voluntary compliance, the tax system operates by altering modes of individual behaviour. It is not therefore just a set of legislated rules.

In January 2005 the Tax Reform Task Force was established by Presidential Order No. 27 to investigate all possible options for tax reform and make appropriate recommendations. After wide-ranging research and consultation they reached a consensus on several recommendations (June 2005) which includes the following:

1. Replace the Gross Revenue Tax (GRT) with a Net Profits Tax (NPT)
2. Replace the States sales tax with a Value Added Tax (VAT)
3. Establish a new Unified Revenue Authority (URA) to replace the existing State and National tax offices. The URA will be charged with responsibility to oversight the collection of all taxes, National and State.
4. Reform the rate structure of the wages and salaries tax to include a tax free threshold.

Tax reform stalled for a number of reasons:

1. The URA model was not acceptable to all States;
2. Many business people did not understand how a VAT works and that the businesses only collect the VAT but it is the final consumer who actually pays. Thus there was considerable push back from the business community;
3. The VAT replaced the State sales taxes. So taxes that had originally belonged 100% at the State level would now be split 50/50 with the National Government
4. The proposed Tax Reform was not revenue neutral but proposed to lift tax effort from 12% of GDP to 16% of GDP in one hit. Put another way, tax revenue would have increased from $36 million to $48 million in one year, an increase of 33 percent, mainly to be paid by households.

The two most recent State & National Leadership Conference in 2017 have requested that the National Government revisit tax reform with the idea of coming up with an acceptable package to all States. Consultations on this exercise have begun.

FSM Trust Fund

The FSM National Government 2023 Action Plan had two key initiatives, the freeing up and spending of the infrastructure grant to facilitate growth in the economy, and $10 million annual investment in the FSM Trust Fund to save for the future.

The FSM Trust Fund was established through Public Law 10-150 in April 1999 and Public Law 13-48, September 2004, gave the President the authority to transfer the appropriated balance of $7,015,000 in the FSM Trust Fund to the Compact Trust Fund as the National Government's contribution to the Fund. This transfer took place on September30, 2004, reducing the Fund balance to zero. The current status of the FSM Trust Fund is shown in table 1 below.

Table 1: FSM Trust Fund Balance ($ millions)

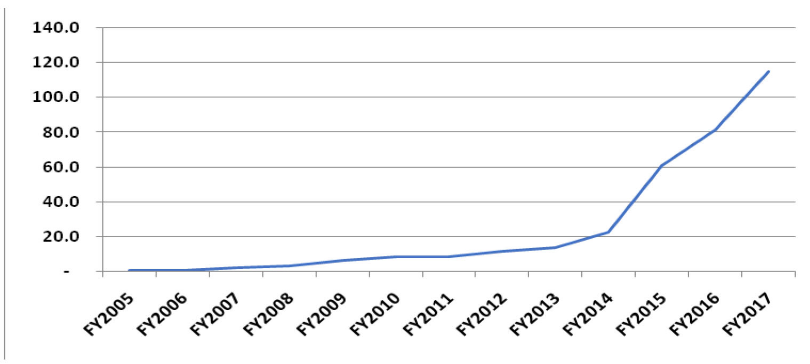
	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Net Assets, Beginning	8,2	8.0	11.3	13.6	22.4	60.9	81.5
Appropriations		1.8	1.0	7.0	38.0	15.2	22.0
Investment income:	-0.2	1.5	1.3	1.8	0.4	5.5	11.5
Net Assets, Ending	8.0	11.3	13.6	22.4	60.9	81.5	115.0

Source: FSM Department of Finance & Administration

From FY2007 to FY2013 the National Government invested $11 million into the FSM Trust Fund (refer figure 4 below). Additional deposits to the FSM Trust Fund were made by Congress Resolutions 15-88 (FY2008) and 16-97 (FY2010) sourced from Chinese Grants of $1 million each. The National Congress made a considerable deposit into the FSM Trust Fund of $7 million in FY 2014 and this has been further increased with a $38 million investment in FY 2015.

From FY 2016, through Public Law No. 18-107, the National Congress has committed $5 million of tax revenue annually to the FSM Trust Fund on behalf of the States. The 2023 Action Plan proposes a further $10 million per annum from National Government surpluses be invested into the FSM Trust Fund with a target Fund value of $250 million by FY 2023, providing around $10 million in annual contribution to the expected $40 million deficit from FY 2024 onwards.

Figure 4: FSM Trust Fund Balance ($ million)



The FY 2017 budget appropriation allowed for a further $17 million investment into the FSM Trust Fund and the fund balance increased to $115.0 million as of September 30, 2017. The most recent forecasts for the FSM Trust Fund will see a balance of $275 million in 2023 allowing for investment income to the States of $12-15 million to supplement the Compact Trust Fund distribution.

Conclusions and Recommendations

As noted in the GAO Report, the end of U.S. compact grants in FY 2023 and the beginning of disbursements from the Compact Trust Fund in FY 2024 will likely require difficult budgetary choices at the State levels. This combined with uncertainty over some key US Federal education grants and programs such as the Post Office, FDIC, Civil Aviation, and FEMA support will put further stress into a fragile economy. Getting some form of certainty at an early stage will help prepare FSM for this transition.

The FSM is very supportive of the three recommendations in the Report and will ensure its Compact Trust Fund Committee members work diligently to implement the recommendations in a timely manner.

The lack of the trust fund distribution policies required under the trust fund agreements is also hampering FSM's efforts to plan for the potential reduction in U.S. Compact assistance after 2023. Some work has already been undertaken on behalf of the Compact Trust Fund Committee by Mercer's, including instigating the "glide path" to better position the Fund for disbursement in 2023. The FSM would like to see the continuation of this work with Mercer on modelling the likely distribution policy options and it will play its part by working with the States to determine what the Trust Fund can finance.

The level of the Compact Trust Fund at present and the likely scenarios for 2023 suggests that the Fund may only have sufficient investment return to finance the operations of Education and Health. These two sectors are critically important for FSM to give stability to the State Government finances. The National Government will work with the States in the upcoming months to better understand how Trust Fund distributions might be allocated and what other sources can be used for small sectors and infrastructure financing.

In addition, without the required fiscal procedures governing trust fund actions after 2023, the trust fund committees will be unable to make disbursements and the United States and the FSM will not have assurance of necessary oversight of trust fund disbursements. The FSM views the new fiscal procedures agreement as key in the next stage in the relationship between the two nations. Moving to a budget support model with financial accountabilities through the annual single audit and performance accountabilities through the medium-term budget framework and annual report can set the overall guidance for this new agreement.

The third recommendation, regarding timing of calculation of distribution is not likely to be a major issue as it is most likely to be resolved with the setting of the distribution policy. A model that takes average fund size for the previous 3-years would resolve this issue. Also, under the current grant allocations the inflation adjustment is only an estimate at the beginning of each fiscal year and this would also be the case for the Compact Trust Fund distribution when determining the real value of the corpus.

Whatever the outcomes of this work over the next couple of years it will be important at an early stage to determine whether the US Congress will be required to make any amendments to the Trust Fund law to allow for these to pass before 2024. We would welcome the thoughts from the United States on this point as we proceed to develop distribution policies as contemplated in the Trust Fund Agreement.

GAO's comments on the Federated States of Micronesia letter dated April 23, 2018.

GAO Comments

1. The FSM refers to our testimony in 2002 regarding the potential for the FSM compact trust fund to not provide funds sufficient to cover the estimated value of expiring federal services as early as 2002.[1]
2. The FSM includes a graphic showing the effect of the partial inflation adjustments and the decrement in the compact sector grants. We include a similar portrayal of this analysis in figure 10 in this report.
3. The FSM states that the amount of the decrement in compact sector grants that is used for annual contributions to the FSM compact trust fund should be recorded as an FSM contribution to the fund. However, Section 215 of the FSM compact refers to the annually decreasing amounts provided to the compact trust fund as set forth in Section 216 of the FSM compact as United States contributions to the compact trust fund.

[1] GAO-02-857T

Appendix XII: Comments from the Republic of the Marshall Islands

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

EMBASSY OF THE REPUBLIC OF THE MARSHALL ISLANDS
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23 April 2018

Mr. David Gootnick
Director
International Affairs and Trade
Washington, DC

Dear Mr. Gootnick:

The Embassy of the Republic of the Marshall Islands has the honor to forward the attached corrected response and comments by the RMI Government, referencing my letter dated 20 April 2018, to the draft GAO report entitled, "Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income, GAO-18-415."

Sincerely,

Gerald M. Zackios
Ambassador of the Republic of the Marshall Islands to the United States

Cc: Hon. John Silk, Minister of Foreign Affairs and Trade, Republic of the Marshall Islands
Mr. Bruce Kijiner, Secretary of Foreign Affairs and Trade

RESPONSE AND COMMENTS OF THE GOVERNMENT OF THE REPUBLIC OF THE MARSHALL ISLANDS TO THE U.S. GOVERNMENT ACCOUNTABILITY OFICE REPORT "ACTIONS NEEDED TO PREPARE FOR THE TRANSITION OF MICRONESIA AND THE MARSHALL ISLANDS TO TRUST FUND INCOME"

The Government of the Republic of the Marshall Islands (RMI) takes this opportunity to thank the United States Government Accountability Office for its draft report "COMPACTS OF FREE ASSOCIATION – Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income". This report, due for publication in May, 2018, will assist both governments in preparation for Compact provisions and federal programs post 2023. The GAO Report also dovetails with the bi-lateral Reviews of Section 104(h)(2) of 108-188 that deal with many of the same issues as this GAO Report.

The focus of this report is the Trust Fund for the People of the Republic of the Marshall Islands (RMI Trust Fund) and what measures need to be taken between now and 2023, when it is expected to produce sufficient income to provide economic assistance to the Sectors set forth in Compact Section 211 of the Compact.

Now on page 43.

Recommendations: page 39

There are three recommendations in the draft GAO report that apply to the RMI Compact Trust Fund; (1) develop a distribution policy for the RMI Trust Fund as required by the Trust Fund Agreement (TFA) that takes into account potential strategies that could address risks to the Fund's ability to provide a source of income after FY 2023; (2) work to develop fiscal procedures required by the TFA; and, (3) work on measures to address the timing of the calculation of Trust Fund disbursements.

The RMI agrees with all three recommendations, subject to the following comments.

Now on page 27.

Page 25

The draft report uses the term "maximum allowable disbursements" when discussing distribution policy to mean the amounts set forth in Article 16, Section 7 of the TFA which specifically deals with distributions starting in FY 2024. The amount referenced in this section (Annual Grant Assistance in 2023 plus Full inflation) is the amount to be provided by the Trust Fund[1]

Further, the amounts set forth in the TFA can be supplemented by additional amounts that the RMI designates as "Special Needs" as defined and provided in the distribution provisions of the TFA.[2] For example, if there is no or inadequate funding to replace the current Supplemental Education Grant (SEG), The RMI may designate additional amounts of funds from the Trust Fund as Special Needs to cover these costs.

The discussions on future Trust Fund distribution policy to date have not considered these provisions, and have instead only dealt with the sustainability of the Trust Fund while failing to consider the needs and requirements of the RMI Government, or the actual provisions of the TFA itself. For example, there has been little discussion, and no decision by the Committee as to whether the Trust Fund is to be considered a "perpetual fund" or a "sinking fund" when distributions start.

See comment 1.

[1] This has been an issue of some debate with the United States Government since the TFA first came into effect. RMI maintains that absent some accountability issue which could result in withholding funds, the amounts set forth in this Article are the amounts to be made available to the RMI from the Trust Fund. There are no written provisions to support "up to…" the amounts provided in the TFA. In addition the C Account is based on the established annual distribution of trust fund income for a period of three years.

[2] In Part I, Article I, the TFA defines "Special Needs "as" projects that the Government of the Republic of the Marshall Islands deems necessary as a supplement to that portion of an annual budget to be financed by the Fund, so long as the project(s) are for the purposes of Section 211 of the Compact, as amended."

These are matters that the Committee should take up and decide before considering actual distribution policy options.

The RMI also notes the risk of zero year distributions and to the need to deal with that risk which will likely include amending the TFA, however, cautions that there needs to be a way to deal with the zero year distribution risk separate and apart from the distribution policy that is set forth in the TFA.

Now on pages 33-34.

Page 28

While there has been some discussion of future distribution models for the Trust Fund, there have been no discussions on future fiscal procedures and accountability provisions.

The TFA provides: "The Trust Fund Committee shall determine the fiscal procedures, including remedies, to be used in implementing this Agreement, provided that the Fiscal Procedures Agreement referred to in sections 211 and 213 of the Compact, as amended, together with any amendments to it over the 20-year period of the Compact, as amended, shall be the basis for such fiscal procedures, unless otherwise agreed by the Original Parties."[3]

There are two possible procedures to establish future accountability provisions for Trust Fund income distributions. The first is through the Trust Fund Committee using the current Fiscal Procedures Agreement which establishes the JEMFAC and is applicable to U.S. Compact sector grant assistance as "the basis" for Trust Fund accountability provisions. Since future Trust Fund income will not be U.S. Grant assistance[4], it is questionable whether accountability provisions or future fiscal procedures can be based on the current FPA.

[3] Article 16, Section 10(1)(a) RMI Trust Fund Agreement

[4] The Fund is held by a non-profit District of Columbia corporation and is comprised of contributions and income from three different governments to date, with the possibility of other future contributors.

The second way to develop future accountability provisions is through agreement of the Original Parties (U.S. and RMI governments). The RMI believes that this is the preferable way to proceed and avoid the problem of trying to re-shape an agreement that is based on a non-applicable system of accountability and fiscal procedures.

Now on pages 34-36.

Page 30

The RMI fully agrees with the GAO's report regarding issues of disbursement timing. These issues are technical in nature rather than policy and were not foreseen at the time of negotiation and approval by either government. Nonetheless, these issues need to be addressed in order to have a smooth transition from annual grants to trust fund income in FY 2024, and to provide the RMI government adequate opportunity to plan its budget process.

In addition to the RMI Trust Fund issues raised in the draft report, the RMI would note the following:

Tax and Trade Contributions Owed to the RMI Trust Fund

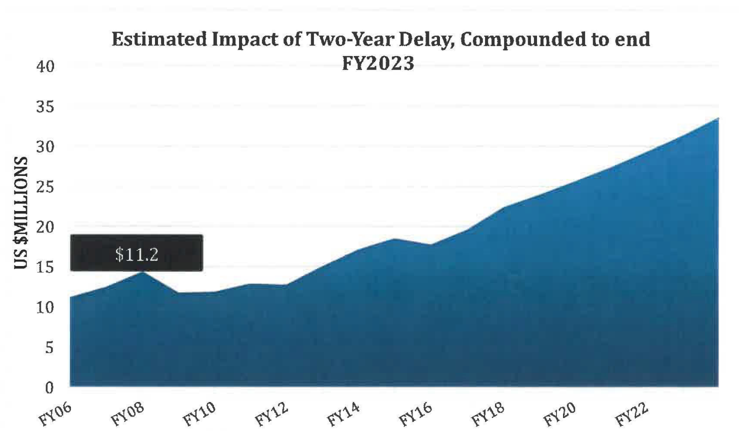
The United States should keep its commitment to the RMI under both the original Compact, and Compact, as amended and appropriate funds to make the contribution of at least $20 million provided in Section 216 (b) of the Compact and Section 108 (b) of PL 108-188, and Section 111(d) of PL 99-239. This is an issue which dates back to the original Compact and unilateral changes that the U.S. Congress made to the agreed to tax and trade provisions at the time. This issue remained unfulfilled when the Compact, as amended, was negotiated, and the RMI agreed to place the balance of the compensation owed into the new RMI Compact Trust Fund which was agreed to by the United States. This contribution to the RMI Trust Fund will greatly assist in improving its viability and sustainability in future years.

Amendments to the TFA

The RMI Government recommends that Section 101(d) of Public Law 108-188 should be amended to allow the RMI and U.S. Governments to agree on amendments to the Trust Fund Agreement by placing any agreed amendments before Congress for period of 90 days as provided in Section 101(f). This would facilitate timely action by the TFC to address many of the issues discussed by the GAO in this report.

Failure to Timely Implement the TFA

Annual Grant Assistance should continue for an additional 2-3 years before Trust Fund income is utilized based on the fact that the Trust Fund will not be invested for 20 years, as provided in the Trust Fund Agreement, and was only fully invested in accordance with the TFA in late 2006.[5] This has resulted in a significant shortfall to the corpus of the Trust Fund as shown in the following graph:



[5] Part I, Article 1 of the TFA provides "Trust Fund Period" means the period that begins twenty (20) years after the effective date of the Compact, as amended.

See comment 2.

The Graduate School USA has estimated the impact of the two-year delay in getting the RMI Compact Trust Fund fully invested. They assume the funds had been invested timely at the outset of FY2004 in the same investment allocation as was used by the RMI starting exactly two years later at the outset of FY2006[6]. The difference of full investment during those two years through the end of FY2005 is estimated at $11.2 million. Using actual performance of the fund through FY2017 and projected performance through FY2023, the estimated loss compounds to $33.6 million as shown in the figure above. This amount compares closely to the amount that would be contributed to the fund by the US by way of a two-year extension of the economic assistance.

Requirement to seek additional Subsequent Contributors

The RMI and US Governments have a fiduciary obligation under the TFA[7] to attract subsequent contributors and need to make adjustments to the TFA conducive to attracting additional subsequent contributors in furtherance of these efforts. The RMI brought Taiwan in as an additional contributor in 2005, but there has been little effort to bring in additional contributors as provided in the TFA. Additional Subsequent Contributors could do much to improve the sustainability of the Trust Fund post 2023.

C Account

The Trust Fund rules for Account C does not allow revolving amount to exceed three times the amount of Fiscal Year 2023 allocation in real terms after 2023. Should the corpus earn income over the 6%, that excess will be able to replenish Account C allowing and enabling for a budget allocation. However, with poor

[6] Graduate School USA, "Technical Note: Estimating the Impact of Delays in Funding the FSM & RMI Compact Trust Funds," April 2018.
[7] Article 11, Section 3 of the TFA provides "The Original Parties shall seek contributions to the Fund from other sources. *(emphasis added)*

performance and no income earned, the possibility of Account C not holding sufficient funds is high. Even with income earned at up to 6%, Account A will still not be able to provide funding for annual budgets.

Other Issues

Renewing the Federal Programs and Services Agreement and Extending Federal Programs Provided in US PL 108-188.

Section 221 of the Compact provides the authority for several federal programs and services to be made available to the RMI by way of a separate agreement, the Federal Programs and Services Agreement (FPSA). These programs and services include U.S. Postal Services; the United States Weather Service; the U.S. Federal Aviation Administration; the U.S. Department of Transportation (Economic Authority); and U.S. Disaster Assistance. These programs were renewed in 2003 for 20 years and will expire at the end of FY 2023 unless action is taken. All of the foregoing federal services provide essential assistance to the RMI and cannot be replaced in terms of available resources by a small island nation like the RMI.

See comment 3.

The U.S. Compact of Free Association Amendments Act of 2003 (U.S. Public Law 108-188) also extended several important federal programs (in addition to creating the Supplemental Education Grant discussed above). Notably, Section 105(1)(B)(i) and (ii) provide for continuing Special Education programs and Pell Grants to continue in the RMI through FY 2023. In the case of the Special Education programs (SEG), there is great concern on the uncertainty of the continuation of SEG and the eligible programs under it. Currently, SEG is funding programs worth $5.7 million that has been contributing to school improvements programs throughout the years and to name a few:

a. Accreditation ($143k)
b. Professional Development ($519k)
c. School Enrichment Program ($158k)
d. Adult Basic Education ($288k)

e. Kindergarten ($1.7m)
f. Textbooks and Supplies ($656k)
g. Data Improvement Project ($278k)
h. Personnel Expenditure ($2.1m-all programs under SEG)

GAO's comments on the Republic of the Marshall Islands letter dated April 23, 2018.

GAO Comments

1. The RMI states that, absent accountability issues, the maximum annual disbursement amount should be disbursed from the compact trust fund. However, as our report notes, although the compact trust fund agreements state the maximum allowable disbursement level, they do not establish or guarantee a minimum disbursement level.
2. The RMI states that the 2-year delay in investing the compact trust fund will result in a compounded total loss of $33.6 million by the end of fiscal year 2023. Our 2007 analysis of the trust funds included information about the delays in establishing the trust funds.[1] We did not update our 2007 analysis of the loss in income due to the delay in investing the compact trust fund for this report.
3. The RMI notes that the amended compacts' implementing legislation extended several important federal programs. Appendix IV of this report presents our conclusions, based on our analysis of current law, that the RMI will remain eligible as of the end of fiscal year 2023 for special education programs and for some programs replaced by the supplemental education grant.

[1] GAO-07-513, pp. 15-20

Appendix XIII: GAO Contact and Staff Acknowledgments

GAO Contact

David Gootnick, (202) 512-3149 or gootnickd@gao.gov

Staff Acknowledgments

In addition to the contact named above, Emil Friberg (Assistant Director), Ming Chen, Neil Doherty, Mark Dowling, Reid Lowe, Moon Parks, Shaundra Patterson, and Michael Simon made key contributions to this report. Justin Fisher, Jeff Isaacs, Julie Hirshen, Risto Laboski, Courtney LaFountain, and Jeffery Malcolm provided technical assistance.

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