ECONOMIC AND FINANCIAL ANALYSIS

A. Background

1. The Public Financial Management Project was approved in October 2017 to help improve public financial management (PFM) in the Marshall Islands by strengthening institutional capacity in the Ministry of Finance (MOF). The current project allocates $2.3 million, inclusive of Asian Development Fund project grants and government contributions, toward supporting the implementation of the government's PFM Reform Roadmap[1] as well as state-owned enterprise (SOE) reforms to reduce the fiscal burden from subsidies. This proposed $550,000 additional financing aims to scale up support, focusing on three reform components in the Roadmap: (i) improving tax administration, (ii) upgrading accounting systems, and (iii) strengthening the PFM legal and policy framework.

B. Current Project

2. In the Marshall Islands, PFM and SOE operations are among the weakest in the Pacific. As such, wasted resources resulting from inefficiencies in public spending and service delivery are likely to be substantial. Further, government subsidies to the Marshall Islands' SOEs averaged the equivalent of 4.4% of gross domestic product (GDP) over fiscal years (FY) 2004–FY2017. This is significantly higher than in comparator North Pacific economies, where subsidies to SOEs averaged 0.4% of GDP, e.g., in the Federated States of Micronesia.[2] Further, the burden of SOE subsidies in the Marshall Islands appears to be increasing, reaching a high of $15.5 million (7.5% of GDP) in FY2017. Sizeable spending efficiency gains appear to be achievable through targeted PFM and SOE management reforms, which will free up scarce fiscal resources. These resources can then be channeled toward more productive expenditures, including essential social services such as health and education.

3. To facilitate the implementation of the Roadmap, a reform coordination unit (RCU) was established through the current project, focusing on the following core functions: public finance, financial management, and human resources.[3] A reform expert has been appointed to the RCU to help (i) identify and estimate the cost of legitimate community service obligations (CSOs), particularly for the country's largest SOEs, to streamline subsidies to match public service delivery costs; and (ii) establish an SOE monitoring unit within the MOF (drawing on existing MOF staff) and build capacity within the unit to monitor SOE performance and ensure the government obtains value for money from its fiscal support to SOEs.[4]

C. Additional Financing

4. On the revenue side, the Marshall Islands' tax–GDP ratio—averaging 16.8% from FY2013 to FY2017—remains below the median (17.4%) among Pacific economies over the same period.

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1 Government of the Marshall Islands. 2014. *Public Financial Management Reform Roadmap 2014–2016*. Majuro.

2 No subsidies to state-owned enterprises were recorded in Palau during FY2004–FY2018, but grants to extra-budgetary units have been rising.

3 The functions were selected based on discussions with the government and development partners. The World Bank approved a $9.5 million grant project in 2018 that will focus on replacing 4Gov, the Marshall Islands' financial management information system, and updating related business processes.

4 The International Monetary Fund has highlighted that clarifying the CSOs of SOEs and establishing a centralized monitoring unit, building on the legislation of the SOE Act, 2015, will be important. International Monetary Fund. 2016. Republic of the Marshall Islands: 2016 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Republic of the Marshall Islands. *IMF Country Report*, No. 16/260. Washington, DC.

The relatively low ratio can be attributed to inefficiencies in the tax system as well as weaknesses in tax administration capacity. The current tax system has several loopholes, contributing to substantial tax arrears that have accumulated over time but cannot be accurately estimated. Under the proposed additional financing, the RCU will review and update recommendations from a tax reform commission 2010 report for phased implementation. The RCU and MOF will also explore the potential of value-added taxes in boosting revenue collection.

5. The additional financing will also support the upgrading of accounting systems, safeguarding the integrity of financial data as the Marshall Islands moves from 4Gov to a modern financial management information system.[5] This will involve mapping old chart of accounts codes to the new system. To strengthen the PFM legal and policy framework, the RCU will, under the supervision of MOF, prepare an updated fiscal responsibility bill to replace the outdated legislation in place. The updated fiscal responsibility legislation will be more suited for present economic conditions and will help improve fiscal transparency.

D. Proxy Cost–Benefit Analysis

6. **Current project.** The main direct benefits from the current project derive from the effective use of fiscal space that will be generated from a sustained reduction in SOE subsidies, when CSOs are fully identified and their costs determined, and inefficiencies eliminated.[6] The analysis assumed that SOE subsidies would gradually reduce to generate fiscal space equivalent to 0.5% of GDP by the end of FY2020 as a result of the reforms.[7]

7. The current project's benefits were estimated to total \$5.1 million, comprising \$3.4 million mainly from more productive use of increased fiscal space and \$1.7 million from multiplier effects on broader economic activity. Against a cost of \$2.3 million, the current project's benefit–cost ratio was estimated at 2.2:1.0 (Table 1).

Table 1: Estimated Benefit–Cost Ratio for the Current Project

Cost ($ million)	**Benefit** ($ million)	**Benefit–Cost Ratio**
2.3	3.4 *(direct benefits)*	1.5
	1.7 *(multiplier effects on GDP)*	0.7

GDP = gross domestic product.
Note: Direct benefits of the project are expected to emanate from the effective use of increased fiscal space.
Source: Asian Development Bank.

8. **Additional financing.** Similar to the current project, benefits from the proposed additional financing will be from the effective use of extra fiscal space. In this case, however, increased fiscal space will be derived from the revenue side, with improved tax administration reducing foregone revenues from leakages. The resulting increased fiscal space is then assumed to be channeled

[5] In 2018, the Marshall Islands secured financing from the World Bank for a new financial management information system that has the potential to significantly improve major government processes such as budgeting, procurement, performance monitoring, and reporting.
[6] The proposed project involves technical assistance rather than investment, and a standard cost–benefit analysis is therefore not applicable.
[7] This will reduce SOE subsidies in the Marshall Islands to the equivalent of 5.9% of GDP—a conservative scenario given that SOE subsidies in comparator North Pacific economies of the Federated States of Micronesia and Palau are each below 1.0% of GDP.

to more productive use (e.g., additional resources for essential government services such as health and education, which should contribute to steady gains in labor productivity). More public resources can also be channeled to ensuring sufficient funding of annual operations and maintenance of infrastructure assets, to preserve and prolong their productivity-enhancing benefits. The analysis also assumes the following:

(i) The tax–GDP ratio gradually rises to generate additional revenues and fiscal space equivalent to 0.1% of GDP by the end of FY2024 as a result of the reforms.

(ii) Given the country's high import dependence, the fiscal multiplier—even with a more efficient public expenditure mix resulting from the project—is relatively small at 0.5.[8]

9. Under these assumptions, the proposed additional financing's benefits are estimated to total $1.5 million, of which $1.0 million represents the direct benefit derived from more productive use of increased fiscal space and $0.5 million is from multiplier effects. Against a cost of $0.6 million, a benefit–cost ratio of 2.8:1.0 is estimated for this additional financing (Table 2).

Table 2: Estimated Benefit–Cost Ratio for the Additional Financing

Cost ($ million)	**Benefit** ($ million)	**Benefit–Cost Ratio**
0.6	1.0 *(direct benefit)*	1.9
	0.5 *(multiplier effects on GDP)*	0.9

GDP = gross domestic product.
Note: Direct benefits of the project are expected to emanate from the effective use of increased fiscal space.
Source: Asian Development Bank.

10. **Overall project.** The overall project (current project and additional financing) will generate benefits totaling $6.6 million ($4.4 million mainly from the productive use of extra fiscal space and $2.2 million through multiplier effects on the broader economy). With costs totaling $2.9 million, the overall project's benefit–cost ratio is estimated at 2.3:1.0 (Table 3).

Table 3: Estimated Benefit–Cost Ratio for the Overall Project

Cost ($ million)	**Benefit** ($ million)	**Benefit–Cost Ratio**
2.9	4.4 *(direct benefits)*	1.6
	2.2 *(multiplier effects on GDP)*	0.8

GDP = gross domestic product.
Source: Asian Development Bank
Note: Direct benefits of the project are expected to emanate from effective use of increased fiscal space.

11. **Unquantified benefits.** As noted in the economic and financial analysis for the current project (paras. 6–10), it excludes other efficiency gains from PFM improvements that are more difficult to quantify, including improvements in the strategic allocation of scarce government resources by strengthening linkages between multiyear sector plans and annual budgets. For

[8] ADB analysis suggests that fiscal multipliers for Pacific comparators are about 0.9 for Fiji (which is less dependent on imports), and likely greater than 0.5 for a smaller economy (e.g., Tonga). ADB. 2009. *Taking the Helm: A Policy Brief on a Response to the Global Economic Crisis.* Manila.

example, PFM reforms will facilitate the development of a medium-term budget framework that will support better public investment planning. Budget execution is also seen to improve, guided by more complete, granular, and up-to-date information on within-year progress on spending in priority sectors.

12. Fiscal discipline will also be promoted through improved internal controls, cash flow planning, and commitment controls, as well as by external audits and the wider availability of information on the state of public finances. PFM reforms can also be expected to stimulate revenue mobilization, with system and process improvements in areas such as taxpayer registration, tax administration and compliance, and broader revenue management.

13. Through a combination of greater public revenue mobilization and expenditure efficiency gains, PFM reforms can help generate much-needed fiscal space that can be redirected to more productive use. Such rebalancing will boost the economic stimulus derived from government expenditure and help raise the Marshall Islands' overall growth prospects. The project is therefore considered an economically beneficial activity, particularly given potentially large longer-term spillover effects on broader economic growth and social welfare from improvements in revenue mobilization as well as the quality, efficiency, and composition of public expenditure.

14. The sustainability of reform benefits will be ensured through capacity building measures being undertaken by the RCU, as it works with staff from the MOF and relevant line agencies. Knowledge and skills transfer in crucial areas (e.g., CSO identification and cost estimation, medium-term budgeting, and maintaining the integrity of the COA) will be priorities. If post-project assessments conclude that follow-on capacity building activities are necessary, these can be jointly supported in coordination with other development partners engaged in PFM reforms in the Marshall Islands.