

SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT¹

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Summary.** As in other small and dispersed atoll economies, the Republic of the Marshall Islands faces significant challenges that limit economic opportunities because of geographical remoteness and dispersion. Exposure to external shocks—both climatic and economic, particularly with heavy reliance on external development assistance—compounds economic fragility. Economic provisions under the Compact of Free Association with the United States (US) are scheduled to expire in 2023, and long-term fiscal sustainability amid substantially lower grant assistance inflows represents a major challenge. Weak public financial management (PFM) and inefficient operation of state-owned enterprises (SOEs) are critical constraints to strengthening the fiscal position and improving the allocation of strategic resources.

2. **Fiscal management.** A sharp rise in fishing license revenues following full implementation in 2012 of the vessel day scheme under the Parties to the Nauru Agreement has helped boost government revenues.² From an average of \$1.8 million, or 1.1% of gross domestic product (GDP) during FY2006–FY2011, fishing license revenues rose almost tenfold to an average of \$17.6 million (9.0% of GDP) per year during FY2012–FY2017. Although this shift toward higher fishing license revenues is seen as structural and therefore likely sustainable over the longer term, spending pressures have increased in parallel. SOE subsidies reached a high of \$15.5 million in FY2017, equivalent to 7.5% of GDP, after exceeding government capital expenditures for six successive years. On the revenue side, the tax–GDP ratio (about 16.8% during FY2013–FY2017) remains below the average of Pacific peers, indicating clear room for improving tax policy and administration. The latest assessments by the International Monetary Fund show that the Marshall Islands remains at high risk of debt distress, with the public sector debt–GDP ratio projected to exceed 50% by 2023 and build up sharply thereafter.

3. **Public financial management.** A public expenditure and financial accountability (PEFA) assessment, conducted in 2012, highlighted significant weaknesses in the Marshall Islands' PFM framework (Table).³ Foremost among these are issues relating to weak linkages between multiyear development planning and annual budget processes. Annual budget shares do not necessarily reflect government priorities set out in sector strategies. The absence of a medium-term budget framework also contributes to weak public investment planning. In addition, budget reallocations frequently serve to further de-link policy priorities from sector allocations. Significant portions of government spending are not reflected in annual budget documents, including, for example, annual expenditures from extra-budgetary funds (e.g., the Marshall Islands Social Security Administration and the Marshall Islands Health Fund). Weaknesses in internal controls, cash flow planning, and commitment controls produce constant pressure to keep spending within budgeted allocations. Accounting and reporting limitations hamper effective monitoring of in-year budget execution progress. Although the Public Accounts Committee provides some external

¹ This summary is largely based on Asian Development Bank (ADB). 2016. *Finding Balance 2016: Benchmarking the Performance of State-Owned Enterprises in Island Countries*. Manila; and Government of the Marshall Islands. 2012. *Public Financial Management Performance Report and Performance Indicators (Final Report)*. Majuro.

² Information on the Parties to the Nauru Agreement's vessel day scheme is in ADB. 2016. Managing rising fisheries license revenues in the Pacific: A review of five countries receiving large inflows. *Pacific Economic Monitor*. July. pp. 22–27.

³ Republic of the Marshall Islands. 2012. *Public Financial Management Performance Report and Performance Indicators (Final Report)*. Majuro.

scrutiny and audit—including through public hearings on audit reports—follow-up actions on specific audit findings remain limited.⁴ Other issues include weaknesses in tax administration and management, and the absence of a dedicated MOF website, which limits public access to fiscal information and hampers effective communication of PFM reforms to stakeholders. The MOF has experienced high turnover and loss of senior staff, and has received minimal technical support for 4Gov, the government’s financial management information system.

Table: Key Public Financial Management Challenges in the Marshall Islands

Item	Aggregate fiscal discipline	Strategic resource allocation	Efficient service delivery
Budget credibility	Weak expenditure controls undermine budget credibility and fiscal discipline. Lack of information on expenditure arrears.	Budgets not executed as planned across line ministries, undermining strategic resource allocation.	Frequent in-year changes to the budget that could potentially undermine spending efficiency.
Comprehensiveness and transparency	Budget documents are not comprehensive, with significant unreported operations. Limited active oversight of potential fiscal risks from public enterprises and subnational governments.	Significant off-budget government spending (e.g., social security).	Limited availability of fiscal information to the public weakens the ability of stakeholders to verify if resources are being used efficiently.
Policy-based budgeting	Underlying fiscal policy objectives and macroeconomic assumptions are not explicit in the budget documents.	Weak links between the planning and budgeting processes (i.e., allocating resources to achieve government priorities as set out in costed and agreed sector expenditure strategies).	Limited policy information reduces the legislature’s ability to review budgetary decisions. Lack of a medium-term budget contributes to weak planning, particularly for public investment.
Predictability and control in budget execution	Weaknesses in internal controls, cash flow planning, and commitment controls result in constant pressure to keep spending within budgeted allocations.	Frequent budget reallocations weaken links between policies and planned inter-sectoral budgetary allocations.	Weaknesses in internal controls, cash flow planning, and commitment controls result in constant pressure to keep spending within budgeted allocations.
Accounting, recording, reporting	Lack of systematic information on in-year budget execution reports.		
Effective external scrutiny and audit	Limited role for the legislature in examining fiscal policy before budget appropriations.	Limited scrutiny on the link between government policies and budgetary allocations.	Weak follow-up action to address audit findings.

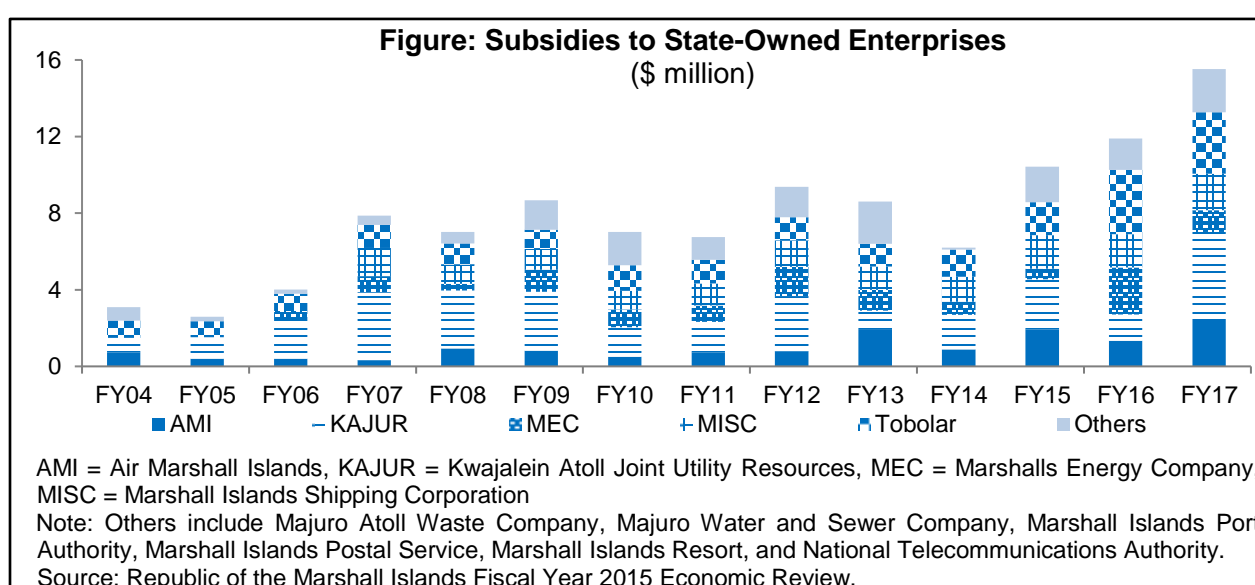
Source: Government of the Marshall Islands. 2012. *Public Financial Management Performance Report and Performance Indicators (Final Report)*. Majuro.

4. **State-owned enterprises.** The performance of the Marshall Islands’ SOE sector is very weak, even compared with other Pacific economies. The Marshall Islands has 11 active SOEs operating in sectors where SOEs are common (e.g., utilities, transport, and telecommunications) but also in hotel administration and copra production. As of 2014, the SOE sector owns 17%–20% of the total capital stock in the economy but contributes only about 5.3% to GDP.⁵

⁴ The US Government Accountability Office conducts periodic reviews of the use and accountability of funds received through the Compact of Free Association. A 2013 report found that the Marshall Islands faces persistent challenges in accountability and noncompliance with US program requirements (e.g., accounting for equipment).

⁵ This translates to a contribution of 0.27%–0.31% to GDP for every 1% share of total fixed capital owned by SOEs in the Marshall Islands. By contrast, SOEs in Kiribati—the best performer in the sample—contribute 0.67% to GDP per

5. SOEs in the Marshall Islands provide a range of public services with noncommercial objectives, while receiving significant government transfers and accessing discounted debt subsidized to fund community service obligations (CSOs). Government subsidies to SOEs during FY2004–FY2017 averaged 4.4% of GDP. Over this period, the recipients of the largest government subsidies were (i) Kwajalein Atoll Joint Utility Resources, the utility providing power, water, and sewerage services to the island community of Ebeye—the second largest urban center; (ii) Tobolar Copra Processing Authority, which is engaged in the processing of copra, mostly from outer-island communities; (iii) Marshall Islands Shipping Corporation; (iv) Air Marshall Islands; and (v) Marshalls Energy Company (Figure). Further, on average, SOEs have paid interest rates about 7.7% lower than prevailing commercial rates on their concessional borrowings since 2012. The subsidized cost of borrowing by SOEs in the Marshall Islands is among the lowest in the Pacific. High annual fiscal contributions pose a significant burden that drains resources away from essential social services, including health and education. To illustrate, net transfers to SOEs totaled more than a third of public expenditure on health during FY2010–FY2014.



6. Reducing the fiscal burden from SOE operations is critical to overall PFM reforms. However, this should proceed in a manner that safeguards the sustainable delivery of CSOs. An important first step will involve a detailed estimation of the legitimate costs of delivering CSOs as mandated for the respective SOEs. Clear identification and proper assessment of CSO costs will help in determining what portion of subsidies effectively finance SOE inefficiencies.

2. Government's Sector Strategy

7. **Public Financial Management Reform Roadmap.** In response to the 2012 PEFA results, the government developed the PFM Reform Roadmap 2014–2016, which consists of 30 reform components, including nonsystem measures for strengthening coordination and oversight. The Roadmap, endorsed by the cabinet in 2015, emphasizes (i) coordinating development partner assistance for PFM reforms; (ii) improving accounting and reporting practices; (iii) clarifying the budgetary framework; (iv) strengthening procurement; (v) enhancing human resources, including payroll systems; (vi) promoting improved fiscal management, including of tax and non-tax revenue,

1% share in total fixed capital. Refer to ADB. 2016 *Finding Balance 2016: Benchmarking the Performance of State-Owned Enterprises in Island Countries*. Manila.

debt, and contingent liabilities; and (vii) monitoring SOEs. The cabinet endorsed the Roadmap in December 2015. A PFM Reform Steering Committee, chaired by the chief secretary, was established in March 2016 to provide high-level management.

8. However, the Roadmap lacks systematic prioritization and effectively remains a wish list, with limited implementation progress amid high staff turnover and insufficient capacity. Understanding of the FMIS system is insufficient, except among staff sufficiently trained in information technology to operate 4Gov but who often lack the non-systems financial knowledge required to generate usable reports. Coordination among internal government agencies on PFM issues is weak. Agencies outside the MOF lack full understanding of their financial reporting responsibilities and are therefore often unable to comply with core financial regulations. There is likewise room to improve development partner coordination in supporting PFM reforms.

9. **State-Owned Enterprises Act.** In October 2015, the Marshall Islands adopted an SOE act to strengthen corporate governance and monitoring of SOEs. The act, developed with support from ADB through its Private Sector Development Initiative technical assistance (TA), provides for SOE commercialization while establishing a sound corporate governance framework.⁶ However, this was weakened by a 2016 amendment that allows elected officials to remain on SOE boards. The TA supports the implementation of the SOE act, focusing on improving transparency, accountability, and financial disclosure. Although the MOF is responsible for implementing the act, this has been constrained by capacity limitations and insufficient understanding of its SOE monitoring role. Line ministers and senior managers from SOEs are also often unable to meet the reporting and accountability requirements under the act. The new centralized SOE monitoring unit, established within the MOF with ADB support in 2018, is expected to address some of these issues.

3. ADB Sector Experience and Assistance Program

10. The Pacific Approach 2016–2020 serves as ADB’s country partnership strategy for the Marshall Islands, and supports: (i) PFM improvements to achieve greater resilience to external shocks, and (ii) increased financial efficiency of SOEs to support a more conducive environment for business.⁷ ADB’s approach to engaging in fragile and conflict-affected situations, including the Marshall Islands, also recognizes the importance of institutional strengthening and capacity building.⁸

11. The project builds on previous ADB support for PFM and SOE reforms. Through two subprograms under the Public Sector Program, ADB assisted in adopting and implementing reform plans to improve the performance of selected SOEs, completing a public sector workforce audit and planning exercise, and achieving specific expenditure targets.⁹ Further, regional TA through the Private Sector Development Initiative has helped the Marshall Islands improve governance within SOEs and develop SOE policy and legislation, develop a fiscal management model, and periodically clear audit backlogs (footnote 6). In-country presence and coordination has been strengthened through the establishment of an ADB Pacific Country Office in the Marshall Islands in 2019.

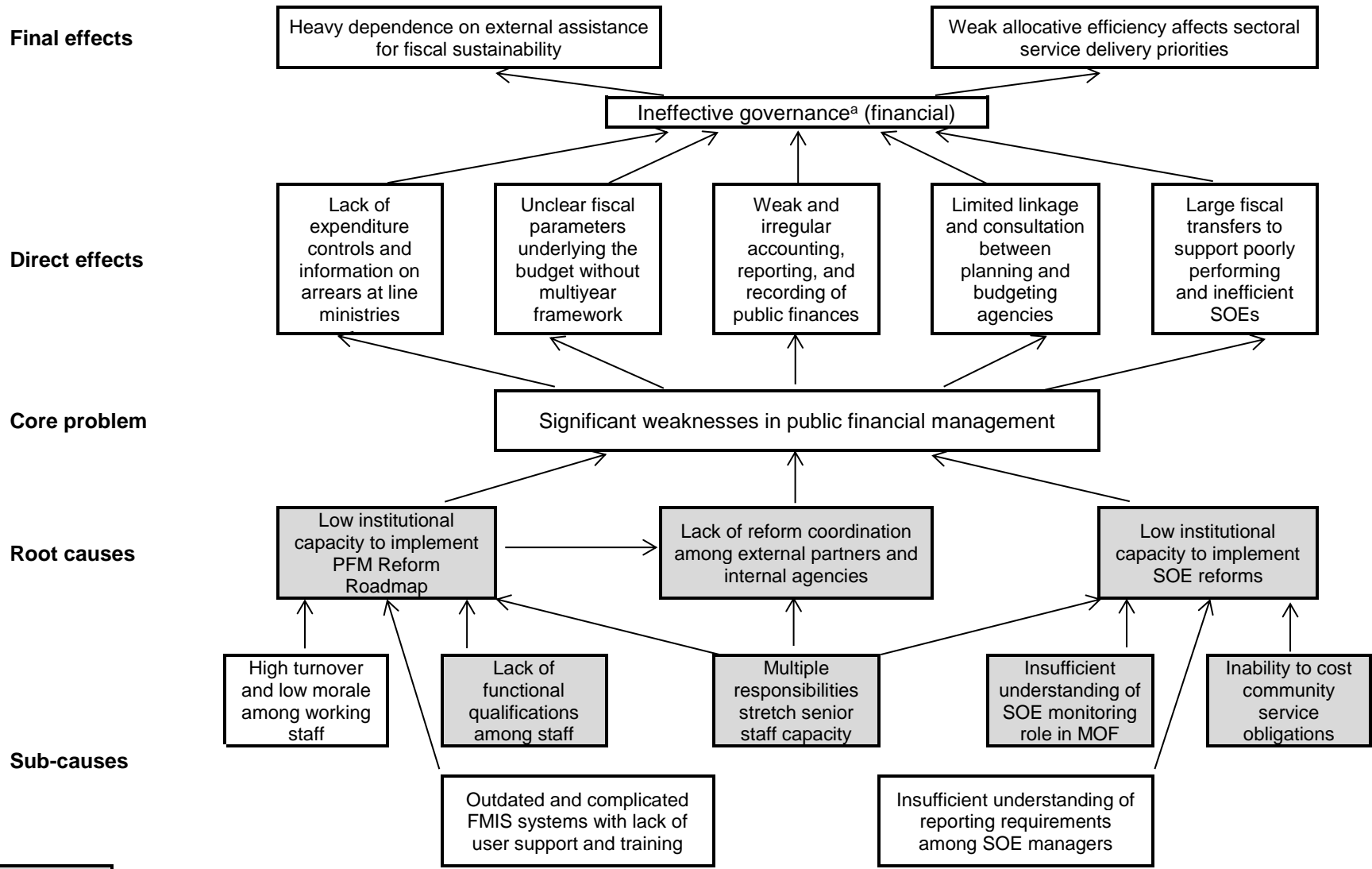
⁶ ADB. 2013. *Pacific Private Sector Development Initiative Phase III*. Manila.

⁷ ADB. 2016. *Pacific Approach, 2016–2020*. Manila.

⁸ ADB. 2013. *Operational Plan for Enhancing ADB’s Effectiveness in Fragile and Conflict-Affected Situations*. Manila.

⁹ ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Program Cluster, Loan for Subprogram 1, and Technical Assistance Grant to the Republic of the Marshall Islands for the Public Sector Program*. Manila; and ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan for Subprogram 2 to the Republic of the Marshall Islands for the Public Sector Program*. Manila.

Problem Tree for Public Sector Management



= Addressed under proposed Asian Development Bank grant

FMIS = financial management and information system, MOF = Ministry of Finance, PFM = public financial management, SOE = state-owned enterprise.

^a Achieving effective governance is a cross-cutting theme of Government of the Marshall Islands. 2014. *National Strategic Plan 2015–2017*. Majuro.