

December 2006

# COMPACTS OF FREE ASSOCIATION

## Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-07-163](#), a report to congressional committees

## Why GAO Did This Study

In 2003, the United States signed Compacts of Free Association with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI), amending a 1986 compact with the countries. The amended compacts provide the countries with a combined total of \$3.6 billion from 2004 to 2023, with the annual grants declining gradually. The assistance, targeting six sectors, is aimed at assisting the countries' efforts to promote economic advancement and budgetary self-reliance. The Department of the Interior (Interior) administers and oversees the assistance. Complying with a legislative requirement, GAO examined, for fiscal years 2004 through 2006, (1) the FSM's and the RMI's use of compact funds, (2) their efforts to assess progress toward development goals, (3) their monitoring of sector grants and accountability for compact funds, and (4) Interior's administrative oversight of the assistance. GAO visited the FSM and the RMI; reviewed reports; and interviewed officials from the FSM, RMI, and U.S. governments.

## What GAO Recommends

GAO recommends, among other things, that Interior work with the FSM and the RMI to establish plans to minimize the impact of declining assistance and to fully develop a reliable mechanism for measuring progress toward compact goals. Interior agreed with all of the recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-07-163](http://www.gao.gov/cgi-bin/getrpt?GAO-07-163).

To view the full product, including the scope and methodology, click on the link above. For more information, contact David Gootnick at (202) 512-3149 or [gootnickd@gao.gov](mailto:gootnickd@gao.gov).

# COMPACTS OF FREE ASSOCIATION

## Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability

### What GAO Found

For 2004 through 2006, compact assistance to the FSM and the RMI was allocated largely to the education, infrastructure, and health sectors, but various factors limited the countries' use of compact funds. Deterrents to the FSM's use of infrastructure funds included constraints on land use and disagreement on project implementation processes. Land use issues also hindered the RMI's use of infrastructure funds. In addition, the FSM's distribution of the grants among its four states resulted in significant differences in per-student education and per-capita health funding. Neither country has planned for long-term sustainability of the grant programs, taking into account the annual decreases in grant funding.

To assess progress toward development goals, the FSM and the RMI established goals and objectives for each sector and are collecting performance data for education and health. However, a lack of complete and reliable baseline data prevents the countries from gauging progress in these sectors. Also, both countries' required quarterly performance reports contained incomplete and unreliable information, limiting the reports' utility for tracking progress. The countries' ability to measure progress is further challenged by a lack of technical capacity to collect, assemble, and analyze baseline and performance data.

Although the FSM and the RMI are required to monitor day-to-day sector grant operations, their ability to meet this requirement for 2004 through 2006 was limited. According to officials in the respective governments, the responsible offices have insufficient staff, budgets, and time to monitor grant operations. In addition, both countries' single audit reports for 2004 and 2005 indicated weaknesses in their ability to account for the use of compact funds. For instance, the FSM's audit report for 2005 contained 57 findings of material weaknesses and reportable conditions in the national and state governments' financial statements for sector grants, and the RMI's report contained 2 such findings. Furthermore, both countries' single audit reports indicated noncompliance with requirements of major federal programs. For example, the FSM's audit report for 2005 contained 45 findings of noncompliance, while the RMI's audit report contained 11 findings.

Interior's Office of Insular Affairs (OIA) has conducted administrative oversight of the sector grants by monitoring the countries' sector grant performance and spending, assessing their compliance with sector grant conditions, and monitoring the audit process. In response to shortcomings that it identified, OIA took several actions, such as withholding or suspending grant funding and ensuring the provision of technical assistance. However, OIA's oversight has been limited by the need to deal with challenges facing the FSM, such as its difficulty in preparing budgets, as well as by its own staffing challenges.

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**Abbreviations**

FAC	Federal Audit Clearinghouse
FSM	Federated States of Micronesia
HHS	Department of Health and Human Services
JEMCO	Joint Economic Management Committee (FSM)
JEMFAC	Joint Economic Management and Financial Accountability Committee (RMI)
KADA	Kwajalein Atoll Development Authority
OCM	Office of Compact Management (FSM)
OIA	Office of Insular Affairs (Department of the Interior)
OMB	Office of Management and Budget
RMI	Republic of the Marshall Islands
SEG	Supplemental Education Grant

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December 15, 2006

### Congressional Committees

From 1987 through 2003,<sup>1</sup> the United States provided \$2.1 billion in economic assistance to the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) through a Compact of Free Association. In 2000, we reported that the U.S., FSM, and RMI governments had provided limited accountability over spending, and that U.S. assistance had resulted in little economic development in both countries.<sup>2</sup> In 2003, the U.S. government approved amended compacts with the FSM and the RMI.<sup>3</sup> These compacts provide for a combined total of \$3.6 billion for the two countries between 2004 and 2023,<sup>4</sup> with the Department of the Interior's (Interior) Office of Insular Affairs (OIA) responsible for administering and monitoring U.S. assistance.<sup>5</sup> U.S. grant funding will decrease annually, paired with increasing contributions to trust funds for the FSM and the RMI; earnings from the trust funds are intended to provide a source of revenue when the grants expire in 2023. The amended compacts identify the 20 years of grant assistance as intended to assist the FSM and RMI governments in their efforts to promote the economic advancement and budgetary self-reliance of their people. Recently we reported that both countries face obstacles to achieving these goals, including limited potential for long-term growth; limited progress in economic reforms; and

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<sup>1</sup>In this report, all annual references refer to the fiscal year rather than the calendar or school year, unless otherwise noted.

<sup>2</sup>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).

<sup>3</sup>Whereas the original compact (approved in Pub. L. No. 99-239, Jan. 14, 1986) was one agreement among the U.S., FSM, and RMI governments, the amended compacts (approved in Pub. L. No. 108-188, Dec. 17, 2003) are separate agreements between the United States and each of the two countries.

<sup>4</sup>The \$3.6 billion in assistance includes (1) compact grants; (2) trust fund contributions; (3) Kwajalein impact funding; (4) estimated values of compact-authorized federal services, such as weather, aviation, and postal services over the 20-year period; and (5) inflation adjustments. Services related to disaster relief have been excluded.

<sup>5</sup>Administrative and monitoring responsibility for U.S. assistance to the FSM, the RMI, and the Republic of Palau is delegated to the Secretary of the Interior and carried out by OIA.

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significant dependence on public sector funding, which is largely supported by external assistance.<sup>6</sup>

The amended compacts require the countries to target funding to six sectors—education, health, the environment, public sector capacity building, private sector development, and infrastructure, with priority given to education and health. The amended compacts’ subsidiary fiscal procedures agreements<sup>7</sup> require the FSM and RMI governments to monitor the day-to-day operations of sector grants and activities, submit periodic performance reports and financial statements, and ensure annual financial and compliance audits. In addition, the compacts and fiscal procedures agreements require that the U.S. and FSM Joint Economic Management Committee (JEMCO) and the U.S. and RMI Joint Economic Management and Financial Accountability Committee (JEMFAC) meet at least once annually to evaluate the progress of the FSM and the RMI, respectively, in achieving the objectives specified in their development plans; approve grant allocations; review required annual reports; identify problems encountered; and recommend ways to increase the effectiveness of compact grant assistance.<sup>8</sup>

The amended compacts’ implementing legislation instructs GAO to report, for the 3 years following the enactment of the legislation and every 5 years thereafter, on the FSM’s and the RMI’s use and effectiveness of U.S. financial, program, and technical assistance as well as the effectiveness of

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<sup>6</sup>GAO, *Compacts of Free Association: Development Prospects Remain Limited for Micronesia and the Marshall Islands*, [GAO-06-590](#) (Washington, D.C.: June 27, 2006).

<sup>7</sup>These agreements contain detailed requirements concerning implementation of the amended compacts’ funding and accountability provisions. The U.S. fiscal procedures agreements with the FSM and the RMI are formally known as the “Agreement Concerning Procedures for the Implementation of United States Economic Assistance Provided in the Compact of Free Association, as amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia” and the “Agreement Concerning Procedures for the Implementation of United States Economic Assistance Provided in the Compact, as amended, of Free Association Between the Government of the United States of America and the Government of the Republic of the Marshall Islands.”

<sup>8</sup>For our early assessment of implementation progress of the amended compacts, see GAO, *Compacts of Free Association: Implementation of New Funding and Accountability Requirements Is Well Under Way, but Planning Challenges Remain*, [GAO-05-633](#) (Washington, D.C.: July 11, 2005).

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administrative oversight by the United States.<sup>9</sup> This report examines, for 2004 through 2006, (1) the FSM's and the RMI's use of compact funds, (2) FSM and RMI efforts to assess progress toward their stated development and sector goals, (3) FSM and RMI monitoring of sector grants and accountability for the use of compact funds, and (4) Interior's administrative oversight of the assistance provided under the compacts. In addition, appendix II contains information about activities funded by key federal programs. A separate correspondence providing additional information about the FSM's and the RMI's use of compact funds in each of the six sectors is forthcoming.

To address our objectives, we reviewed the U.S., FSM, and RMI annual compact reports for 2004 and 2005; OIA grant documents for 2004 through 2006; FSM and RMI strategic planning documents, performance budgets, and quarterly performance reports for 2004 and 2005, as available; and FSM and RMI single audits<sup>10</sup> for 2001 through 2005. We observed 2005 and 2006 JEMCO and JEMFAC meetings. In addition, we interviewed officials from Interior and the Departments of State, Health and Human Services (HHS), and Education. We also interviewed RMI officials and FSM national and state officials in the six sectors receiving compact funding and visited compact-funded facilities and activities in both countries. We determined that the grant, program, technical assistance, and performance data examined in this report are sufficiently reliable for our specific purposes. However, our interviews with FSM and RMI officials revealed important limitations in the financial and activity data in the countries' performance reports. We conducted our work from October 2005 to December 2006 in accordance with generally accepted government auditing standards. (For additional details of our objectives, scope, and methodology, see app. I.)

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## Results in Brief

In 2004 through 2006, the FSM and RMI governments' allocations of compact grants prioritized the education and health sectors, as the compacts require, but the countries' use of compact funds was constrained

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<sup>9</sup>Pub. L. No. 108-188. The act requires us to report on political, social, and economic conditions in the FSM and the RMI; this information has been issued in [GAO-06-590](#). We will be providing additional information on the trust funds in 2007.

<sup>10</sup>The FSM and the RMI are required to conduct annual audits within the meaning of the Single Audit Act, as amended. The act, as amended, is codified in Chapter 75 of Title 31 of the *United States Code*. For the purposes of this report, we refer to the required annual audits as "single audits."

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by several factors. Education, health, and infrastructure accounted for 34 percent, 21 percent, and 25 percent, respectively, of the FSM's compact funds and for 33 percent, 20 percent, and 40 percent of the RMI's compact funds. In both countries, use of the funds was hampered by political factors and land use issues. In the FSM, disagreement among the national and state governments<sup>11</sup> regarding project implementation and fund management delayed infrastructure projects, and the government's inability to secure land leases hindered project implementation in Chuuk. In the RMI, political disagreements between the government and Kwajalein Atoll landowners over the management of compact fund distribution delayed the release of funds allocated for special needs on the island of Ebeye,<sup>12</sup> and disagreements over land use prevented infrastructure projects in the Majuro and Kwajalein Atolls. Neither country has planned its allocation and use of funds for long-term sustainability in view of the planned annual decrements in grant funding<sup>13</sup> and yearly inflation, for which the grants are only partially adjusted.<sup>14</sup> Although representatives of both countries told us that increased tax revenues could replace declining compact funds, economic experts consider the countries' business tax schemes to be inefficient. Furthermore, the FSM's grant allocations have been distributed according to prescribed percentages rather than the states' varying populations and needs.

Although the FSM and the RMI established mechanisms to measure grant performance in each sector, several factors inhibited the countries' ability to assess progress toward stated goals. The FSM and the RMI each established development plans that contain goals and objectives for most sectors and are collecting data for performance indicators for education and health. However, incomplete or unreliable baseline data for some indicators limited both countries' ability to measure progress toward sector goals. In addition, although both countries compiled the required quarterly

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<sup>11</sup>The FSM comprises the following four states: Chuuk, Kosrae, Pohnpei, and Yap.

<sup>12</sup>Kwajalein Atoll is the second most populated atoll in the RMI, where many residents were displaced within the atoll to provide space for U.S. missile testing. Many of these residents now reside on Ebeye Island.

<sup>13</sup>The decrement in grant funding is deposited into the FSM's and the RMI's trust funds. The RMI's annual decrement of \$500,000 began in 2004, and the FSM's annual decrement of \$800,000 began in 2007.

<sup>14</sup>The compacts provide for a partial inflation adjustment of grant funding. Under the compacts' implementing legislation, after 2014 the funding may be fully adjusted for inflation under certain U.S. inflation conditions.

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performance reports, the reports have limited usefulness for assessing progress, owing to problematic formats in the FSM and to incomplete and inaccurate data on program activities in both countries. For example, although the RMI's private sector development report for the fourth quarter of 2005 states that eight new businesses were created in 2005, officials from the Ministry of Resources and Development indicated that only four businesses had been started that year. A lack of capacity to collect, assemble, and analyze performance data also limited both countries' ability to measure progress toward sector goals.

The FSM and RMI governments provided limited monitoring of sector grant operations, and their single audit reports—particularly those of the FSM—call into question the countries' accountability for all compact funds. Although both governments designated offices responsible for compact management, these offices lack the capacity to conduct the required monitoring of day-to-day sector grant operations. The FSM's Office of Compact Management (OCM), in particular, has not been fully staffed. In addition, both countries' single audit reports contained findings and opinions that call into question the usefulness and reliability of their financial statements. Of the FSM's national and state audit reports for 2004 and 2005, only one state report showed no problems with financial statements. Furthermore, both countries' audit reports contained findings of noncompliance with requirements of major U.S. programs—for example, the FSM's 2005 reports contained 45 such findings, and the RMI's 2005 report contained 11. In 2006, the FSM and the RMI developed corrective action plans that address 60 percent and 100 percent, respectively, of the 2005 findings.

OIA provided administrative oversight of the countries' sector grants, but its oversight was hampered by several challenges. OIA monitored the countries' sector grant performance, fiscal performance, and sector grant outlays and assessed the countries' compliance with sector grant conditions. OIA's efforts also included actions such as suspending or withholding grant payment in response to persistent shortcomings that it identified in the FSM. OIA's administrative oversight of the compacts was constrained by the need to respond to persistent problems in the FSM as well as the office's difficulty in filling staff positions.

In this report, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of JEMCO and JEMFAC, to work with the FSM and the RMI to undertake planning to minimize the impact of reduced future funding; fully develop mechanisms

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for measuring sector grant performance; and improve the reliability of information used by the FSM, RMI, and U.S. governments to monitor the compacts.

The Assistant Secretary of Policy, Management and Budget, Department of the Interior, provided written comments on a draft of this report, stating that the report was accurate, well balanced, and concurred with our recommendations (see app. VIII). The FSM also commented on a draft of the report, characterizing it as a balanced and fair assessment of its progress in planning for sustainability, measuring progress, and ensuring accountability. The FSM, however, defended its distribution formula for allocating compact funds to the national and state governments (see app. IX). The RMI government noted that its decisions, in light of budgeting constraints, to refrain from expanding ministry staffs has affected its capacity for performance monitoring and reporting; it also provided several comments regarding our discussion of the grant decrements (see app. X). In addition, the Departments of State, Education, and Health and Human Services provided technical comments, which we incorporated where appropriate.

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## Background

U.S. relations with Micronesia and the Marshall Islands began during World War II, when the United States ended Japanese occupation of the region. The United States administered the region under a United Nations trusteeship beginning in 1947.<sup>15</sup> The four states of the FSM voted in a 1978 referendum to become an independent nation, while the Marshall Islands established its constitutional government and declared itself a republic in 1979. Both locations remained subject to the authority of the United States under the trusteeship agreement until entry into force of the compact in 1986.

The FSM is a loose federation of four states, and has a population of approximately 108,500,<sup>16</sup> scattered over many small islands and atolls. The FSM states maintain considerable power, relative to the national government, to allocate U.S. assistance and implement budgetary policies.

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<sup>15</sup>The Department of the Navy began civil administration of these islands on July 18, 1947. This responsibility was transferred to Interior in July 1951.

<sup>16</sup>Mark Sturton, *Federated States of Micronesia: Fiscal Year 2005 Economic Review* (June 2006).

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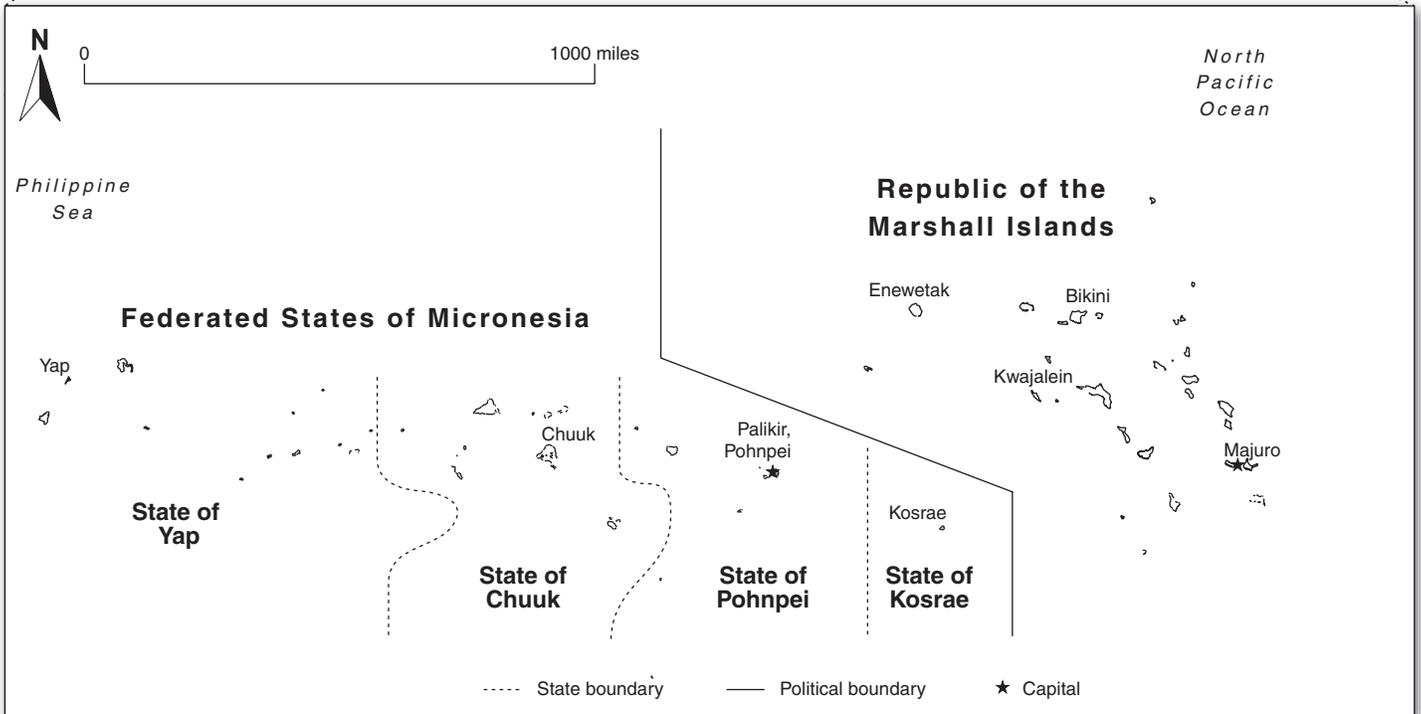
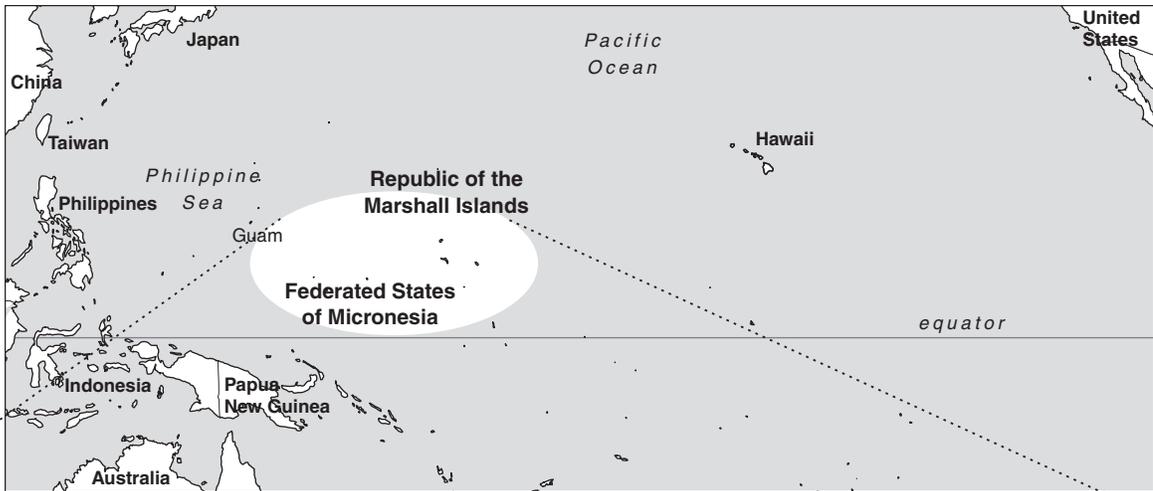
Chuuk, the largest state, has 50 percent of the FSM's population, followed by Pohnpei (32 percent), Yap (11 percent), and Kosrae (7 percent). The RMI has a constitutional government, and its 29 constituent atolls have local government authority. About two-thirds of its approximately 56,000<sup>17</sup> residents are in Majuro Atoll, the nation's capital, and Kwajalein Atoll.<sup>18</sup> The two countries are located just north of the equator in the Pacific Ocean. (See fig. 1.)

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<sup>17</sup>Mark Sturton, *Republic of the Marshall Islands: Fiscal Year 2005 Economic Review* (June 2006).

<sup>18</sup>Some Marshallese live under urban conditions: 1999 RMI census population density data show that part of Majuro Atoll has a greater density than New York City (2000), while the over 9,000 Marshallese who live on Ebeye Island in the Kwajalein Atoll, experience more than twice the population density of New York City (2000).

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



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

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## Compact of Free Association: 1986 through 2003

The United States, the FSM, and the RMI entered into the original Compact of Free Association in 1986 after lengthy negotiations. The compact provided a framework for the United States and the two countries to work toward achieving the following three main goals: (1) secure 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 first and second goals were met; the FSM and the RMI are independent nations, and the three countries established key defense rights, including securing U.S. access to military facilities on Kwajalein Atoll in the RMI through 2016.<sup>19</sup> The compact's third goal was to be accomplished primarily through U.S. direct financial assistance to the FSM and the RMI. For the 15-year period covering 1987 to 2001, funding was provided at levels that decreased every 5 years, with an extension for 2002 and 2003 during negotiations to renew expiring compact provisions. For 1987 through 2003, the FSM and the RMI are estimated to have received about \$2.1 billion in compact financial assistance.<sup>20</sup> As we previously reported,<sup>21</sup> economic self-sufficiency was not achieved under the first compact.

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 activities, while the RMI emphasized capital spending. Compact funds to the FSM were divided among the FSM's national government and four states, according to a distribution agreement first agreed to by the five governments in 1984. In 2000, we reported that 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

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<sup>19</sup>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).

<sup>20</sup>This estimate represents total nominal outlays. It does not include payments for compact-authorized federal services or U.S. military use of Kwajalein Atoll land, nor does it include investment development funds provided under section 111 of Pub. L. No. 99-239.

<sup>21</sup>GAO, *Compact of Free Association: An Assessment of the Amended Compacts and Related Agreements*, GAO-03-890T (Washington, D.C.: June 18, 2003).

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economic growth.<sup>22</sup> Furthermore, many of the projects undertaken by the FSM and the RMI experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds. While the 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. The “full faith and credit” provision made withholding funds impracticable. In addition, under the original compact, both nations also benefited from numerous U.S. federal programs, while citizens of both nations exercised their right under the compact to live and work in the United States as “nonimmigrants” and to stay for long periods of time.<sup>23</sup>

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## Amended Compacts of Free Association: 2004 through 2023

In 2003, 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.<sup>24</sup> The amended compacts provide for direct financial assistance to the FSM and the RMI from 2004 to 2023, decreasing in most years, with the amount of the decrements to be deposited in the trust funds for the two nations established under the amended compacts<sup>25</sup> (see table 1). Moreover, the amended compacts require the FSM and the RMI to make one-time contributions of \$30 million each to the trust funds, which both

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<sup>22</sup>[GAO/NSIAD-00-216](#).

<sup>23</sup>GAO, *Foreign Assistance: Effectiveness and Accountability Problems Common in U.S. Programs to Assist Two Micronesian Nations*, [GAO-02-70](#) (Washington, D.C.: Jan. 22, 2002); and *Foreign Relations: Migration From Micronesian Nations Has Had Significant Impact on Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands*, [GAO-02-40](#) (Washington, D.C.: Oct. 5, 2001). “Nonimmigrants” is a status that typically signifies nonpermanent visitors, such as tourists or students.

<sup>24</sup>The amended compacts and related agreements addressed most of the recommendations that we had made in past reports. See [GAO-03-890T](#).

<sup>25</sup>The amended compacts’ implementing legislation provides a continuing appropriation until 2023 for the financial assistance.

countries have done.<sup>26</sup> In addition, the RMI amended compact includes an agreement that allows the U.S. military access to certain sites in Kwajalein Atoll until 2086 and provides \$15 million annually starting in 2004, rising to \$18 million<sup>27</sup> in 2014, to compensate for any impacts of the U.S. military on the atoll.<sup>28</sup>

**Table 1: U.S. Assistance to Be Provided to the FSM and the RMI under the Amended Compacts, 2004 through 2023**

Dollars in millions

Fiscal year	FSM grants (Section 211)	FSM trust fund (Section 215)	RMI grants (Section 211)	RMI trust fund (Section 216)	Kwajalein Impact (Section 212) <sup>a</sup>
2004	\$76.2	\$16.0	\$35.2	\$7.0	\$15.0
2005	76.2	16.0	34.7	7.5	15.0
2006	76.2	16.0	34.2	8.0	15.0
2007	75.4	16.8	33.7	8.5	15.0
2008	74.6	17.6	33.2	9.0	15.0
2009	73.8	18.4	32.7	9.5	15.0
2010	73.0	19.2	32.2	10.0	15.0
2011	72.2	20.0	31.7	10.5	15.0
2012	71.4	20.8	31.2	11.0	15.0
2013	70.6	21.6	30.7	11.5	15.0

<sup>26</sup>Other donors are allowed to contribute to the trust funds as well. Taiwan has committed to providing \$50 million to the RMI's trust fund; the FSM has no other benefactor. While the United States, the FSM, and the RMI worked to set up trust fund procedures and policies, and engage money managers and trustees, the funds were deposited into bank accounts. Initial investments of the FSM and the RMI trust funds did not occur until August 2006 and September 30, 2005, respectively.

<sup>27</sup>In 2014, the annual payment will be either \$18 million (not adjusted for inflation) or the 2013 amount with an inflation adjustment, whichever is greater.

<sup>28</sup>However, the RMI government has not reached an agreement with the Kwajalein landowners to extend their current land use agreement. Currently, the RMI continues to compensate the landowners under a 1982 agreement that has been extended to 2016, with an annual payment of \$11.4 million (as of 2004). Per the requirements of the compacts' implementing legislation, in the absence of a new or amended land use agreement reflecting the terms of the amended U.S.-RMI compact subsidiary agreement, the additional funds are accumulating in an RMI government escrow account. Accordingly, if a new or amended land use agreement is not concluded within 5 years after the enactment of the U.S. implementing legislation, the funds and interest earned are to be returned to the U.S. Treasury, unless the RMI and the United States mutually agree otherwise. (The legislation was enacted on Dec. 17, 2003.)

(Continued From Previous Page)

Dollars in millions

Fiscal year	FSM grants (Section 211)	FSM trust fund (Section 215)	RMI grants (Section 211)	RMI trust fund (Section 216)	Kwajalein Impact (Section 212) <sup>a</sup>
2014	69.8	22.4	32.2	12.0	18.0
2015	69.0	23.2	31.7	12.5	18.0
2016	68.2	24.0	31.2	13.0	18.0
2017	67.4	24.8	30.7	13.5	18.0
2018	66.6	25.6	30.2	14.0	18.0
2019	65.8	26.4	29.7	14.5	18.0
2020	65.0	27.2	29.2	15.0	18.0
2021	64.2	28.0	28.7	15.5	18.0
2022	63.4	28.8	28.2	16.0	18.0
2023	62.6	29.6	27.7	16.5	18.0

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

Notes:

Within both the FSM and the RMI annual grant amounts include \$200,000 to be provided directly by the Secretary of the Interior to the Department of Homeland Security, Federal Emergency Management Agency, for disaster, and emergency assistance purposes. The grant amounts do not include the annual audit grant, capped at \$500,000 that will be provided to both countries.

These dollar amounts shall be adjusted each fiscal year for inflation by the percentage that equals two-thirds of the percentage change in the U.S. gross domestic product implicit price deflator, or 5 percent, whichever is less in any one year, using the beginning of 2004 as a base. Grant funding can be fully adjusted for inflation after 2014, under certain U.S. inflation conditions.

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

The amended compacts and fiscal procedures agreements require that grant funding be targeted to support the countries, in six defined sectors, with the following general objectives:

- *Education:* Advance the quality of the basic education system.
- *Health:* Support and improve the delivery of preventative, curative, and environmental care.
- *Environment:* Increase environmental protection and engage in environmental infrastructure planning.
- *Public sector capacity building:* Build effective, accountable, and transparent national, state (in the FSM), and local government and other public sector institutions and systems.

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- *Private sector development:* Attract foreign investment and increase indigenous business activity.
  - *Infrastructure:* Provide adequate public infrastructure, prioritizing primary and secondary education capital projects and projects that directly affect health and safety, with 5 percent dedicated to maintenance.<sup>29</sup>

The RMI must also target grant funding to Ebeye and other Marshallese communities within Kwajalein Atoll: \$3.1 million annually for 2004 through 2013 and \$5.1 million annually for 2014 through 2023. In addition, \$1.9 million is provided from annual grant funds to address special needs within Kwajalein Atoll, with emphasis on the Kwajalein landowners. Other funds are provided to the RMI government related to U.S. use of the atoll for military purposes. (See app. III for Kwajalein-related compact funding provisions.)

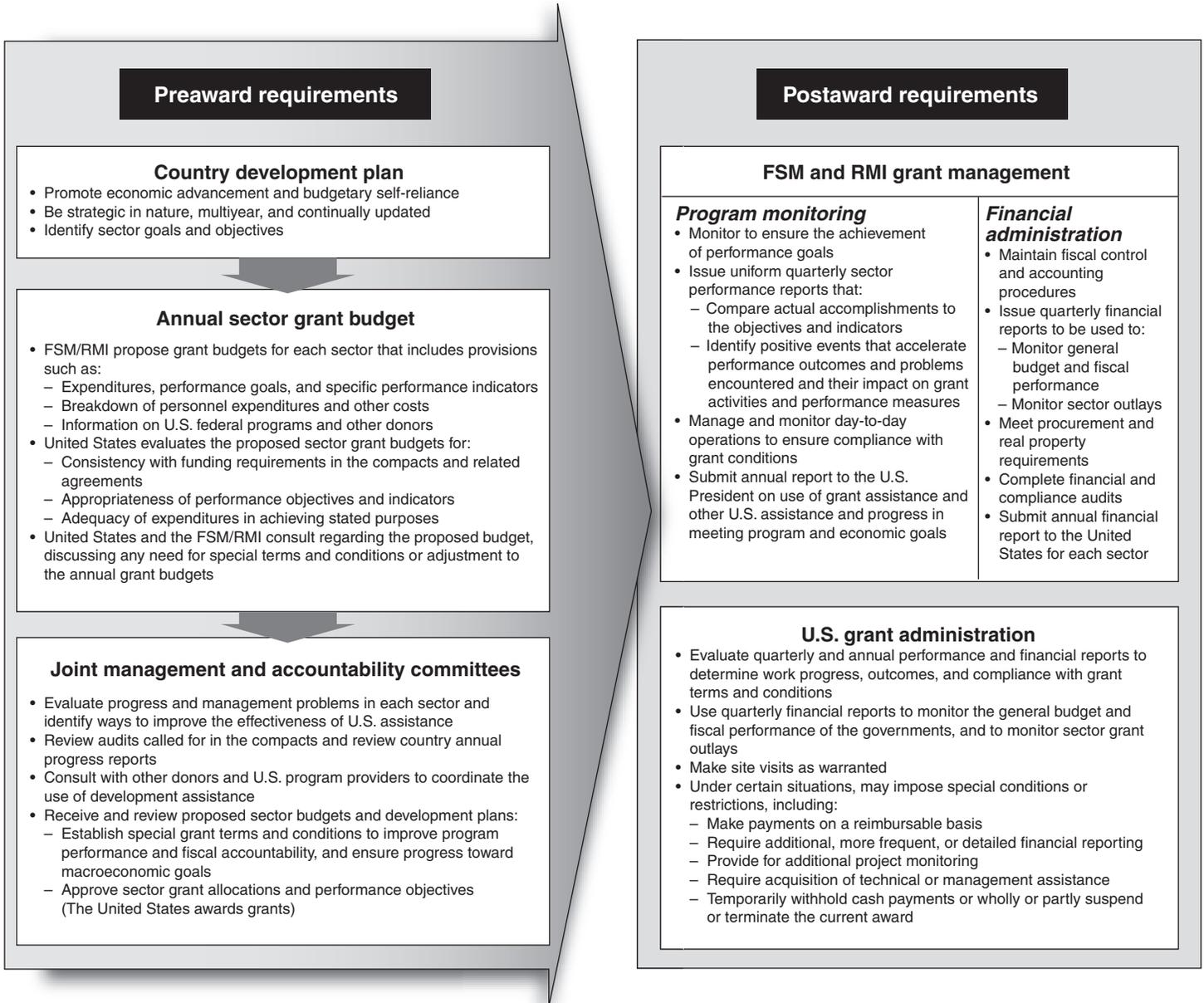
## Implementation Framework

Under the amended compacts and according to the fiscal procedures agreements, annual assistance for the six sectors in the FSM and the RMI is to be made available in accordance with an implementation framework with several components. Prior to the annual awarding of compact funds, the countries must submit development plans that identify goals and performance objectives for each sector. In addition, the countries must submit a budget for each sector that aligns with its development plan. The joint management and accountability committees for each country are to approve annual sector grants and, subsequent to the awards, evaluate sector management and progress. Finally, for each sector, the FSM and the RMI are to prepare quarterly financial and performance reports to serve as a mechanism for tracking progress against goals and objectives and monitoring performance and accountability. Figure 2 shows the amended compact implementation framework.

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<sup>29</sup>In the compacts' implementing legislation, Congress also suggested that the FSM allocate at least 30 percent of its total sector grant allocation toward infrastructure improvement and maintenance. The RMI compact requires its infrastructure grant to be 30 to 50 percent of its total annual sector grants. Regarding the use of those funds, the fiscal procedures agreements further prioritized the use of those funds specifically toward primary and secondary education capital projects and projects that affect health and safety, including water and wastewater projects.

**Figure 2: Amended Compact Implementation Framework**



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

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

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## **Country Development Plan**

Both countries are to develop multiyear development 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.<sup>30</sup> The plans are to identify how the countries will use compact funds to promote broad compact development goals such as economic advancement and budgetary self-reliance. The plans are also to identify goals and objectives for each sector.

## **Annual Sector Grant Budget**

In addition, through the annual budget process, the FSM and the RMI are to prepare annual sector grant budget proposals that are based on the development plans, including performance goals and indicators. U.S. officials are to evaluate the sector budget proposals each year to ensure that they are consistent with compact requirements and have the appropriate objectives and indicators and that the expenditures are adequate to achieve their stated purposes. Budget consultations between the governments are to take place regarding the sector proposals.

## **Joint Management and Accountability Committees**

JEMCO and JEMFAC—jointly established by the United States and, respectively, the FSM and the RMI—are to strengthen management and accountability and promote the effective use of compact funding. Each five-member committee comprises three representatives from the United States and two representatives from the country.<sup>31</sup> JEMCO's and JEMFAC's designated roles and responsibilities include

- reviewing the budgeting and development plans from each of the governments;

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<sup>30</sup>The FSM's development plan is called the Strategic Development Plan. The RMI's development plan consists of three documents: Vision 2018, Meto 2000, and its Medium Term Budget and Investment Framework. In addition, the annual portfolio submissions include strategic goals and indicators for each of the sectors. We refer collectively to all these of these RMI documents as the development plan.

<sup>31</sup>The three U.S. representatives to JEMCO and JEMFAC include one official each from Interior, State, and HHS, with the Interior representative serving as Chairman. A revision, under preparation since 2003, to a 1986 executive order, outlining specific responsibilities of the U.S. agencies regarding compact matters had not been issued as of October 2006.

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- approving grant allocations and performance objectives;<sup>32</sup>
  - 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.

The FSM, the RMI, and the United States are required to provide the necessary staff support to their representatives on the committee to enable the parties “to monitor closely the use of assistance under the Compacts.”

### **FSM and RMI Grant Management**

The FSM and the RMI are responsible for grant management, including managing and monitoring the day-to-day operations and financial administration of each sector.

- *Program monitoring.* The FSM and RMI governments are to manage the sector and supplemental education grants and monitor day-to-day operations to ensure compliance with grant terms and conditions. Monitoring also is required to ensure the achievement of performance goals. The governments are to report quarterly to the United States, using a uniform format that includes
  - a comparison of actual accomplishments to the objectives and indicators established for the period;
  - any positive events that accelerate performance outcomes;
  - any problems or issues encountered, reasons, and impact on grant activities and performance measures; and
  - additional pertinent information, including, when appropriate, an analysis and explanation of cost overruns.

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<sup>32</sup>JEMCO and JEMFAC render decisions by majority vote, except those decisions regarding the division of RMI grants among sectors, which are made by consensus.

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In addition, the FSM and the RMI must annually report to the U.S. President on the use of U.S. grant assistance and other U.S. assistance provided during the prior fiscal year, and must also report on their progress in meeting program and economic goals.

- *Financial administration.* The FSM and the RMI must adhere to specific fiscal control and accounting procedures. The fiscal procedures agreements state that the countries' financial management systems must meet several standards addressing financial reporting, accounting records, internal and budget controls, allowable cost, cash management, and source documentation. The systems must also specify applicable procedures regarding real property, equipment, and procurement. Quarterly financial reports are to be provided to the United States and used to monitor the (1) general budget and fiscal performance of the FSM and the RMI and (2) disbursement or outlay information for each sector grant.

In addition, the FSM and the RMI are required to submit annual audit reports, within the meaning of the Single Audit Act as amended.<sup>33</sup> According to the act, single audit reports are due within 9 months after the end of the audited period.<sup>34</sup> Single audits are focused on recipients' internal controls over financial reporting and compliance with laws and regulations governing U.S. federal awardees. Single audits also provide key information about the federal grantee's financial management and reporting. A single audit report includes

- the auditor's opinion (or disclaimer of opinion, as appropriate) regarding whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting

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<sup>33</sup>For the purposes of this report, our definition of a "single audit" is financial and compliance audits within the meaning of the Single Audit Act, as amended. (See chapter 75 of Title 31 of the U.S.C. § 7501 et seq.) Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, provides audit requirements for audits of nonfederal entities expending over a certain amount of federal awards. The due date for audits can be extended by federal agencies. While the compacts do not reference these policies, U.S. agencies that have programs in the FSM and the RMI would implement these policies with respect to single audits related to federal programs.

<sup>34</sup>The fiscal procedures agreements state that the single audits are to be completed no later than 6 months after the end of the fiscal year (by Apr. 1)—a period that is generally 3 months shorter than that specified in the Single Audit Act, as amended. However, OIA considers the 6-month requirement in the fiscal procedures agreements to be an error and is allowing the FSM and the RMI 9 months to complete their audits.

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principles, and findings about the internal controls related to financial statements;

- the entity's audited financial reporting;
- the schedule of expenditures of federal awards and the auditor's report on the schedule;
- the auditor's opinion (or disclaimer of opinion) regarding whether the auditee complied with the laws, regulations, and provisions of contracts and grant agreements (such as the compact), which could have a direct and material effect on each major federal program, as well as findings on internal controls related to federal programs;
- a summary of findings and questioned costs for the federal program; and
- corrective action plans for findings identified for the current year as well as unresolved findings from prior fiscal years.<sup>35</sup>

### **U.S. Grant Administration**

The United States is responsible under the fiscal procedures agreements for using the performance and financial reports to monitor, respectively, the countries' sector grant performance and their budget and fiscal performance. Also, U.S. officials are responsible for monitoring compliance with grant terms and conditions, including any special grant conditions. If problems are found in areas such as the monitoring of sector grants or a lack of compliance with grant terms, the United States may impose special conditions or restrictions, including requiring the acquisition of technical or management assistance, requiring additional reporting and monitoring, or withholding funds.

Under the implementing legislation, the U.S. President is required to report annually to Congress on the use and effectiveness of U.S. assistance. The President's report also is to include an assessment of U.S. program and

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<sup>35</sup>The Single Audit Act requires that recipients submit their single audit report packages to the Federal Audit Clearinghouse. While the fiscal procedures agreements do not address the filing requirement, OIA is using the date of complete filing with the clearinghouse to determine when the country completes the audit process.

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technical assistance provided to the countries and an evaluation of their economic conditions.

According to federal policy implementing the Single Audit Act,<sup>36</sup> U.S. agencies may take actions regarding late audits to ensure that award recipients address audit findings contained in single audit reports. According to the grants management common rule, awarding agencies may issue a high-risk designation to grant recipients if single audits reveal substantial and pervasive problems.<sup>37</sup>

## Compact Management Units

In addition to establishing the joint management and accountability committees, each of the three countries has designated units that are responsible for compact administration.

- *United States.* OIA has responsibility for U.S. management and oversight of the FSM and RMI sector and supplemental education grants. OIA's Honolulu field office<sup>38</sup> has four professional staff—specialists in health, education, infrastructure, and financial management—who perform various activities, such as
  - analyzing FSM and RMI budgets and required reports;
  - reviewing expenditures and performance with FSM and RMI government officials and conducting site visits;
  - providing briefings and advice to OIA, HHS, and State officials regarding progress and problems;

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<sup>36</sup>Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

<sup>37</sup>According to the grants management common rule, a high-risk designation is authorized if a grantee has a history of unsatisfactory performance or otherwise irresponsible actions, such as failing to submit single audit reports in a timely manner or if single audits or other Inspector General investigations reveal substantial and pervasive problems. Such a designation allows the grantor to impose special terms and conditions or sanctions that could result in suspensions or terminations of federal awards. The grants management common rule was established in 1987 under presidential direction to adopt governmentwide terms and conditions for grants to state and local governments. Each federal department incorporates the rule in its agency regulations.

<sup>38</sup>OIA has two additional staff located in the FSM and the RMI, one in Pohnpei and the other in Majuro, who are funded by, and considered part of, the Honolulu office. These staff provide on-the-ground monitoring and grants management follow-up.

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- providing support for JEMCO and JEMFAC meetings;
  - monitoring the countries' compliance with grant terms and conditions; and
  - withholding funds from the countries for noncompliance with requirements such as those expressed in the fiscal procedures agreements or in grant conditions (such remedies did not exist in the previous compact).
- *FSM.* In 2005, the FSM established its Compact Management Board and OCM. The board consists of seven members: two FSM national government appointees, a member appointed by each state, and the head of OCM. The board is responsible for actions such as formulating guidelines for FSM JEMCO members and providing oversight of compact implementation, including conducting investigations to ensure compliance with all terms of the compact. OCM, which has five staff members, is principally responsible for daily communications with JEMCO and the United States regarding JEMCO and compact matters. OCM is expected to undertake various actions, such as visiting the FSM states, to monitor compliance with compact terms.
  - *RMI.* The RMI government identified the Office of the Chief Secretary as the official point of contact for all communication and correspondence with the U.S. government concerning compact sector grant assistance. Among the Chief Secretary's responsibilities are providing oversight management and monitoring of sector grants and activities and coordination. Its role is supported by the Economic Policy, Planning, and Statistics Office, which works with the ministries receiving grants to prepare the annual budget proposals; quarterly reports, including developing performance indicators; and annual monitoring and evaluation reports. The ministries conduct day-to-day oversight.

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## Supplemental Education Grant

In addition to receiving compact sector grants, the FSM and the RMI are eligible for a Supplemental Education Grant (SEG). The amended compacts' implementing legislation authorized appropriations beginning in 2005 to the Secretary of Education to supplement the education grants under the amended compacts. The SEG is awarded in place of grant assistance formerly awarded to the countries under several U.S. education,

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health, and labor programs.<sup>39</sup> Under the fiscal procedures agreements, SEG funds are to be used to support “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.” Funding for the SEG is appropriated to a Department of Education account and transferred to an Interior account for disbursement, with Interior responsible for ensuring that the use, administration, and monitoring of SEG funds are in accordance with a memorandum of agreement among the Departments of Education, HHS, Labor, and the Interior as well as with the fiscal procedures agreements. The U.S. appointees to JEMCO and JEMFAC are required by the compacts’ implementing legislation to “consult with the Secretary of Education regarding the objectives, use, and monitoring of United States financial, program, and technical assistance made available for educational purposes.” JEMCO and JEMFAC are responsible for approving the SEG grants annually.<sup>40</sup>

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<sup>39</sup>The SEGs are awarded in place of grants formerly awarded to the FSM and the RMI under Part A of title I of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 6311 et seq.); title I of the Workforce Investment Act of 1998 (29 U.S.C. 2801 et seq.), other than subtitle C of that act (29 U.S.C. 2881 et seq.) (Job Corps); title II of the Workforce Investment Act of 1998 (20 U.S.C. 9201 et seq.; commonly known as the Adult Education and Family Literacy Act); title I of the Carl D. Perkins Vocational and Technical Education Act of 1998 (20 U.S.C. 2321 et seq.); the Head Start Act (42 U.S.C. 9831 et seq.); and subpart 3 of Part A, and part C, of title IV of the Higher Education Act of 1965 (20 U.S.C. 1070b et seq., 42 U.S.C. 2751 et seq.), according to Pub. L. No. 108-188.

<sup>40</sup>SEG funding is appropriated annually. The provision authorizing the SEG in the amended compacts’ implementing legislation authorizes to be appropriated to the Secretary of Education an annual amount adjusted for inflation (partial) through 2023. A memorandum of agreement among Interior, Education, HHS, and Labor states that Education “shall seek the annual appropriation of funds for the SEGs, including adjustments for inflation, as described in Section 105(f)(1)(B)(iii) of Pub. L. No. 108-188.”

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## Compact Grants Targeted Infrastructure, Education, and Health, but Various Issues Constrained Countries' Use of Funds

JEMCO and JEMFAC approved allocations of compact grants primarily to the infrastructure, education, and health sectors. The FSM and the RMI also both received a new SEG, meant to support the goals and objectives in the education sector development plans. However, the countries' use of compact funds has been limited by several factors, including delays in implementing infrastructure projects in the FSM and ongoing land use disputes with RMI landowners on both Majuro and Kwajalein. In addition, neither country has planned for the scheduled annual decrements in compact funding, and the FSM has not undertaken local needs assessments to target funds.

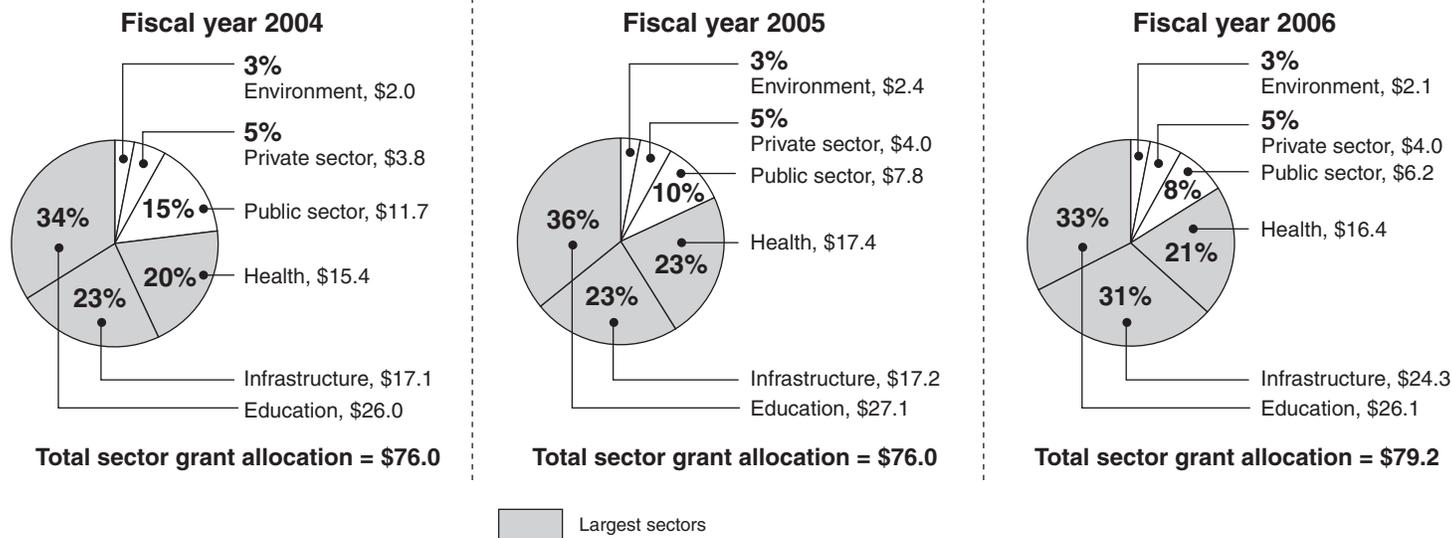
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## Compact Funding Allocation in the FSM

The three largest FSM sectors—education, infrastructure, and health—accounted for almost 85 percent of the compact sector grant allocations in 2006. Of this total, education funding represented 33 percent; infrastructure represented 31 percent, up from 23 percent in 2004; and health represented 21 percent. The other three sectors—public sector capacity building, private sector development, and the environment—together accounted for less than 20 percent of the FSM's compact funding in 2006. Figure 3 shows the FSM sector grant allocations for 2004 through 2006. (See app. IV for a breakout of compact funding, by FSM state.)

**Figure 3: FSM Sector Grant Allocation, 2004 through 2006**

Dollars in millions



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

Note: SEG funds, which started in 2005, are not included in these amounts. Additionally, in cases where funds were unspent and deobligated in one fiscal year, and reobligated in a subsequent fiscal year, we included the funds only in the fiscal year in which they were initially obligated.

In general, the funds allocated for each sector were used as follows:

- Education.** JEMCO approved allocations for the education sector amounting to \$79 million, or 34 percent of compact funds in 2004 through 2006. U.S. assistance is the main source of revenue for the FSM education system. At the FSM national government level, compact funding supports, among other things, the College of Micronesia, the development of national education standards, the national standardized testing program, and the college admissions test. At the state level, the funding is principally targeted to primary and secondary education. Compact funding levels vary among the FSM states, with Chuuk receiving the least funding per student (approximately \$500) and Yap receiving the most (approximately \$1,300). The difference in the funding levels for these two states is directly reflected in student-to-teacher ratios, with Chuuk having a higher student-to-teacher ratio (19:1) than Yap (8:1). Overall, we found the condition of school facilities and the adequacy of their supplies and equipment to be poorer in Chuuk than in the other FSM states. The FSM is making efforts to improve teacher

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qualifications through a grant from Education. Despite some progress, FSM educational outcomes remain poor. For example, according to an official from the FSM's Department of Health, Education, and Social Affairs, graduates of FSM high schools often are not qualified to take college-level courses.

- *Health.* JEMCO approved allocations amounting to \$49 million, or 21 percent of compact funds in 2004 through 2006, for health care activities such as medical and nursing services, dispensary services, and public health services. According to health officials in Chuuk and Pohnpei, funding under the amended compact provided for increased budgets for pharmaceuticals and supplies. However, a 2005 FSM Department of Health, Education, and Social Affairs assessment of primary care reported that most facilities lacked an appropriate range and quantity of medicine and supplies in each of the four FSM states. We found that each of the states' hospitals and primary care facilities lacked some or all of the following: maintenance, adequately trained staff, functional equipment, and medical and pharmaceutical supplies. In addition, health sector allocations varied considerably across the four FSM state governments. For example, in 2006 Yap received more than twice as much health sector funding per person as Chuuk. During our site visits, we observed that Chuuk's hospital and primary care facilities were in the poorest condition of the four states' facilities.
- *Infrastructure.* JEMCO approved allocations amounting to \$58.7 million, or 25 percent of compact funds in 2004 through 2006, to infrastructure. However, the FSM's allocation of funds for 2004 and 2005 did not meet the recommendation in the compact's implementing legislation, which stated that it was the sense of Congress that not less than 30 percent of annual compact sector grant assistance should be invested in infrastructure. In addition, the FSM has not completed any infrastructure projects. As of November 2006, OIA had approved 14 of the FSM's priority projects, including several schools, a wastewater treatment facility, power and water distribution systems, and road and airport improvements. However, construction on these projects had not begun. Furthermore, according to an OIA official, the FSM had not met a compact requirement to establish and fund an infrastructure maintenance fund.
- *Public sector capacity building.* JEMCO approved allocations for public sector capacity building amounting to \$25.6 million, or 11 percent of compact funding in 2004 through 2006. About 12 percent of these

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funds supported the operations of the public auditors' offices in three of the four states and the FSM national government. OIA found that this use of the funds met the grant's purpose. However, according to OIA, most of the remaining funds were to be used to support basic government operations, rather than for the grant's intended purpose of developing the internal expertise needed to build an effective, accountable, and transparent government. In 2004, JEMCO required that the FSM develop a plan to eliminate funding for such nonconforming purposes by 2009. The FSM submitted a plan to OIA that illustrates an annual reduction of such funding, but the plan does not detail how the nonconforming activities, such as those supporting public safety and the judiciary, will otherwise be funded. FSM officials told us that they plan to replace capacity-building funds in part with local monies. However, recent tax revenues have largely stagnated despite some improvements.<sup>41</sup>

- *Private sector development.* JEMCO approved private sector allocations amounting to \$10.2 million, or 5 percent of compact funding in 2004 through 2006. These funds supported more than 38 different offices throughout the FSM—including visitor bureaus, land management offices, and marine and agriculture departments—and economic development and foreign investment activities.
- *Environment.* JEMCO approved allocations for the environment amounting to \$6.6 million, or 3 percent of compact funding in 2004 through 2006. These funds supported 21 offices throughout the four states and the FSM national government, including offices responsible for environmental protection, marine conservation, forestry, historic preservation, public works, and solid waste management.

In addition to receiving compact sector funding, the FSM education sector also received \$24 million in SEG funds in 2005 and 2006.<sup>42</sup> However,

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<sup>41</sup>GAO-06-590.

<sup>42</sup>The FSM received \$12,083,360 in SEG funds for 2005, and \$12,059,401 for 2006. The 2006 SEG, which was awarded in September 2006, was not adjusted for inflation and was subject to a federal budget rescission.

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SEG funding was “off cycle”<sup>43</sup> in both years. As a result, according to Interior, the FSM did not receive its 2005 SEG funding until October 2005 and did not receive its 2006 SEG funding until September 2006, near the end of each fiscal year. In Chuuk and Pohnpei, SEG funding mainly supported early childhood education, while in Yap and Kosrae, the largest portion of SEG funding went to school improvement projects that provided supplemental instructional services, such as after-school tutoring and professional development programs. The SEG funding also supported vocational training, skills training, and staff development. In addition, the FSM national government received some SEG funding for monitoring, coordination, technical assistance, and research. The College of Micronesia received SEG funds for financial aid for students and for training students to be teachers through the teacher corps.

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## Compact Funding Allocation in the RMI

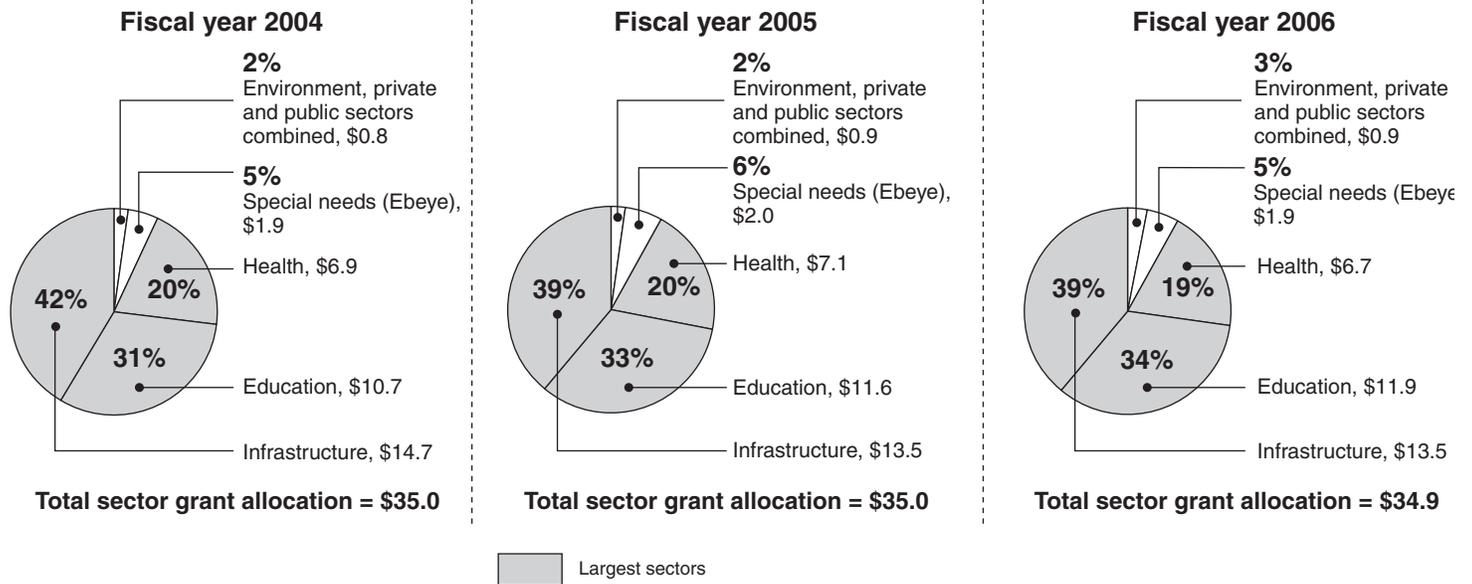
The three largest RMI sectors—infrastructure, education, and health—accounted for 92 percent of the compact sector grant allocations in 2006. Infrastructure received approximately 40 percent of the funding between 2004 and 2006, while education received approximately 33 percent and health received approximately 20 percent. Funding was also allocated for Ebeye special needs; however, only a small portion had been expended as of August 2006. As in the FSM, public sector capacity building, private sector development, and the environment received the least compact funding, totaling less than 4 percent between 2004 and 2006. Figure 4 shows the sector grant allocations for the RMI for 2004 through 2006. (See app. IV for a breakout of compact funding, by RMI sector grants.)

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<sup>43</sup>Off-cycle funds are those not received at the beginning of the fiscal year for which they were appropriated. Because the FSM did not receive SEG funds until the end of the fiscal year, domestic funding was used to cover the SEG cost. The delayed SEG funds were used to reimburse the expenses that had been incurred.

**Figure 4: RMI Sector Grant Allocation, 2004 through 2006**

Dollars in millions



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

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

- Education.** JEMFAC approved allocations for the education sector amounting to \$34.2 million, or 33 percent of compact funds in 2004 through 2006. These funds have primarily supported the operations of the primary and secondary schools, providing approximately \$800 per student annually. In addition, compact education funding has supported the National Scholarship Board and the College of Marshall Islands. Furthermore, some 2004 through 2006 funding was designated specifically for Ebeye’s schools. The quality of school facilities varies widely in the RMI. Although new classrooms were built with infrastructure funds, we found that many existing classrooms remained in poor condition. For example, in several Marshall Island High School classrooms, ceilings had fallen in, making the classrooms too dangerous to use. The RMI is making efforts to improve teacher qualifications through a grant from Education. However, although improved educational outcomes is a compact priority, standardized test scores show that RMI educational outcomes remain poor. Moreover, according

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to the College of the Marshall Islands, graduates of RMI high schools often are not qualified to take college-level courses.

- *Health.* JEMFAC approved allocations amounting to \$20.6 million, or 20 percent of compact funds in 2004 through 2006, for health care activities such as medical and nursing services, dispensary services, and public health services. A large portion of this funding was allocated to hospital service improvements, such as hiring additional staff, providing specialized training for doctors and nurses, and purchasing equipment in both Majuro and Ebeye.
- *Infrastructure.* JEMFAC approved allocations amounting to \$41.7 million, or 40 percent of compact funds in 2004 through 2006, for infrastructure—thereby meeting the RMI compact requirement to allocate at least 30 percent, and not more than 50 percent, of annual compact sector grant assistance funds to this sector. Furthermore, the RMI undertook and completed several infrastructure projects and established and funded an infrastructure maintenance fund, as required. From October 2003 to July 2006, 9 new construction projects and 17 maintenance projects in the RMI either were completed or were under way. All of the new projects were schools where there was a clear title or an existing long-term lease for the land.<sup>44</sup>
- *Environment, private sector development, and public sector capacity building.* JEMFAC approved allocations of \$2.6 million, or 3 percent of compact funds in 2004 through 2006, for these three sectors. This funding supported four entities, including the Environmental Protection Authority; the Land Registration Authority; the Office of the Auditor General; and Ministry of Resources and Development, which comprises the Small Business Development Council and the Marshall Islands Visitors' Authority. The RMI's Chief Secretary indicated during our meeting in March that the RMI would no longer seek compact funds for activities in these sectors and would instead focus all compact resources on education, health, and infrastructure.

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<sup>44</sup>The fiscal procedures agreements require that evidence of title, leasehold agreement, or other legal authority for use of land upon which a capital improvement project is to be constructed must be provided to the United States prior to a draw down of funds.

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- *Ebeye*. JEMFAC approved allocations amounting to \$5.8 million, or almost 6 percent<sup>45</sup> of all compact funds in 2004 through 2006, for Ebeye special needs. However, because OIA obligated none of these funds for Ebeye during 2004 and 2005, JEMFAC approved the reallocation of the entire amount in 2006. According to OIA, approximately \$500,000 has been used to pay for utility costs for certain Ebeye residents,<sup>46</sup> while another \$500,000 has been used to support utility operations.

In addition to receiving compact sector funding, the RMI also received \$12 million in SEG funding for 2005 and 2006.<sup>47</sup> However, because SEG funding was off cycle in both 2005 and 2006, according to OIA, the RMI did not receive its 2005 SEG until August 2005 and its 2006 SEG until September 2006, near the end of each fiscal year.<sup>48</sup> The SEG mainly supported early childhood education but also supported activities at other education levels, including the purchasing of textbooks and supplies; supporting foreign volunteer teachers and substitute teachers; and funding the National Vocational Training Institute, which is an alternative to the mainstream high schools.

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## Several Factors Have Limited Countries' Use of Compact Funds

Political factors and land use issues have hindered compact implementation in the FSM and the RMI.

- Political factors.
  - In the FSM, although \$58.7 million had been allocated for infrastructure as of September 2006, no infrastructure projects were built because of, among other issues, a lack of internal agreement

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<sup>45</sup>The funds were supposed to be allocated to the Kwajalein Atoll Development Authority, which experienced problems in effectively and efficiently using funds in the past. In early 2005, RMI legislation was passed that contained plans for KADA's restructuring, but the agency was still not operating as of October 2006, according to an RMI official. Instead, the Marshall Island's government allocated funds to the utility.

<sup>46</sup>Specifically, funding for utilities went to displaced midcorridor residents residing in Ebeye.

<sup>47</sup>The RMI received \$6,100,000 in SEG funds for 2005, and received \$5,941,769 for 2006. The 2006 SEG, which was awarded in September 2006, was not adjusted for inflation and was subject to a federal budget rescission.

<sup>48</sup>Because the RMI did not receive the SEG funds until the end of the fiscal year, domestic funding was used to cover SEG costs. The delayed SEG funds were used to reimburse the expenses that had been incurred.

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among the five FSM governments regarding project implementation and the governments' inability to demonstrate how the funding will be managed in a unified and comprehensive method. For example, one FSM state governor told us that he had refused to meet with the FSM national government's project management unit because he so strongly disagreed with the unit's management process. Such disagreements led to delays in the national government's implementation of its project management unit, and, according to OIA officials, significant challenges remain with respect to implementing the unit.

- In the RMI, the government and landowners on Kwajalein Atoll disagreed about the management of the entity designated to use the compact funds set aside for Ebeye special needs, with an emphasis on the needs of Kwajalein landowners. This entity, the Kwajalein Atoll Development Authority (KADA), had had problems accounting for and effectively and efficiently using funds; moreover, according to the RMI's Chief Secretary, the RMI government developed a restructuring plan for the authority but the plan was not fully implemented. Moreover, Kwajalein landowners disputed the composition of the KADA board and its role in distributing these funds. As a result, as of September 2006, only approximately \$1.0 million of the \$5.8 million allocated for Ebeye special needs had been released for the community's benefit.
- Land use issues.
  - In the FSM, project implementation in Chuuk was hindered by the state's inability to secure leases due to the lack of clear title, established fair market values, and local revenues to pay for land leases.<sup>49</sup> Because of a lack of established fair market values, using compact funding for land lease or purchase under the original compact may have led to unreasonably high payment. A recent study<sup>50</sup> of land valuation practices in Chuuk found sales of comparable land in Weno, the state's capital, ranging from \$5 per

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<sup>49</sup>JEMCO addressed this issue in 2004, resolving that no use of compact funds for payments toward preexisting land purchase arrangements or leases will be allowed.

<sup>50</sup>Neil K. Darroch, *Land Consultancy & Valuation – Government Leased Land Chuuk State*, a special report requested by the Asian Development Bank on behalf of the FSM (August 1998).

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square meter to \$1,704 per square meter, with the higher payment associated with lease agreements paid for by the compact funding.

- In the RMI, land disputes prevented construction of the Uliga Elementary School on Majuro, the country's main atoll, while another project site on Majuro was abandoned because a lease agreement could not be concluded with the landowner. On Kwajalein Atoll, construction of Kwajalein Atoll High School was delayed because of the inability of the RMI government to secure a long-term lease from Kwajalein landowners for a site large enough to accommodate new facilities for up to 600 students. Similar problems delayed construction of Ebeye Elementary School. RMI projects were built where the land titles were clear and long-term leases were available. However, future RMI infrastructure projects may be delayed because of uncertainty regarding the land titles for remaining projects.

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### Lack of FSM and RMI Planning for Decrement Threatens Sustainability of Government Services

The FSM and the RMI lack concrete plans for addressing the annual decrement in compact funding and, as a result of revenue shortfalls, will likely be unable to sustain current levels of government services as compact funding diminishes. In both countries, compact funding represents a significant portion of the government revenue—approximately 38 percent in the FSM<sup>51</sup> and 27 percent in the RMI, according to the 2005 single audits. Personnel expenses account for a substantial share of compact funding expenditures. For example, 57 percent of the education sector grant in the FSM and 75 percent of the grant in the RMI paid for personnel in 2006. Over the past 5 years, government employment has grown in both countries:<sup>52</sup> in the FSM, the public sector employment level has varied since 2000 but peaked for this period in 2005, while in the RMI, the government wage bill rose from \$17 million in 2000 to \$30 million in 2005. Given the countries' current levels of spending on government services, the decrement—\$800,000 per year for the FSM, beginning in 2007, and \$500,000 per year for the RMI since 2005—will result in revenue shortfalls in both countries, absent additional sources of revenue. In addition, in the FSM, cessation of nonconforming

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<sup>51</sup>The reliance on compact sector funding as a source of government revenue varies, with compact funding accounting for 61 percent of the government revenue in Chuuk, 58 percent in Kosrae, 52 percent in Pohnpei, 31 percent in Yap, and 13 percent in the national government, according to data from the single audits.

<sup>52</sup>[GAO-06-590](#).

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uses of the public sector capacity building grant will require government operations currently supported by compact funds to rely on a different revenue source.

Officials in the FSM and the RMI told us that they can compensate for the decrement in various ways, such as through the yearly partial adjustment for inflation, provided for in the amended compacts,<sup>53</sup> or through improved tax collection. However, the partial nature of the adjustment causes the value of the grant to fall in real terms, independent of the decrement, thereby reducing the government's ability to pay over time for imports, such as energy, pharmaceutical products, and medical equipment. Moreover, as we recently reported,<sup>54</sup> although tax reform may provide opportunities for increasing annual government revenue in the FSM and the RMI, the International Monetary Fund, the Asian Development Bank, and other economic experts consider both nations' business tax schemes to be inefficient because of a poor incentive structure and weak tax collection. In the FSM's and the RMI's response to our draft report, both countries raised the possibility that the decrement's negative effect might be addressed during the periodic bilateral review, which is called for every 5 years, under the compact.

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### FSM Sector Fund Allocation Was Not Based on Population or Informed by State Needs

The FSM distributed compact funding among its four states according to a formula that did not fully account for states' differing population sizes or funding needs. The formula, established in an FSM law enacted in January 2005 and in force through 2006, allotted a set percentage to each state as well as 8.65 percent to the national government.<sup>55</sup> Use of the distribution formula resulted in varying per capita compact funding among the states (see table 2). For example, we calculated that in 2006, Yap received more than twice as much education funding per student and health care funding per person as Chuuk.

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<sup>53</sup>Grant funding is partially adjusted for inflation, although it can be fully adjusted after 2014 under certain U.S. inflation conditions.

<sup>54</sup>[GAO-06-590](#).

<sup>55</sup>As of 2007, absent an agreement between the chief executive of the national government and each state government, a revised distribution formula provides 10 percent of total grant funding to the FSM national government. The accordingly reduced FSM state allocations maintain the same proportions with respect to each other. According to OIA, the 2007 grants reflect the increased share for the FSM national government.

**Table 2: Distribution of Compact Funds to FSM States and States' Percentages of FSM Population, 2006**

FSM state	Percentage of compact funds allotted to state	Percentage of FSM population in state (estimated)
Chuuk	42%	50%
Kosrae	12	7
Pohnpei	28	32
Yap	18	11
<b>Total</b>	<b>100%</b>	<b>100%</b>

Source: GAO analysis of FSM Public Law 13-93 and the *Federated States of Micronesia: Fiscal Year 2005 Economic Review*.

Note: The FSM public law distributes 8.65 percent of total compact funding to the FSM national government, which leaves 91.35 percent of compact funds available to the states. To compare the distribution of funds with the distribution of population among the four FSM states, we subtracted the funding allocated to the FSM national government from the total distributed. Expenditures by the national government, such as support for the College of Micronesia, benefit the economies of all the states but provide greater benefits to Pohnpei, which contains the largest of the college campuses and the FSM capitol.

Both the FSM government and U.S. officials acknowledged that the funding inequality resulted in different levels of government services across states, with particularly low levels of services in Chuuk. For example, an FSM health official told us that Chuuk's low immunization rate is a result of low per-capita health funding, and, according to a U.S. health official, HHS immunization staff see Chuuk as vulnerable. However, as of October 2006, neither the FSM nor JEMCO had assessed the impact of such differences on the country's ability to meet national goals or deliver services.

## FSM and RMI Have Limited Ability to Measure Progress toward Compact Goals

Although the FSM and the RMI established performance measurement mechanisms, several factors limited the countries' ability to assess progress toward compact goals. The FSM and the RMI development plans contain sector goals and objectives, and the countries are collecting performance indicators for health and education. However, neither country can assess progress using these indicators because of incomplete and poor quality data. Moreover, problems in the countries' quarterly performance reports—disorganized structure in the FSM reports as well as incomplete and inaccurate information in both the FSM and the RMI reports—limit their usefulness for tracking performance. A lack of technical capacity also challenges the countries' ability to collect performance data and measure progress.

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## Countries Established Mechanisms for Measuring Performance, but Data Shortcomings Limit Ability to Assess Progress toward Goals

Both countries established development plans that include strategic goals and objectives for the sectors receiving compact funds. These strategic goals are broad—for example, both countries list improving primary health care as a strategic goal. In addition, the development plans list various objectives related to each strategic goal. For example, in the FSM, the objectives related to improving primary health care include (1) increasing by 20 percent the use of basic primary health care services provided at dispensaries and health centers and (2) decreasing by 50 percent the use of primary health care services provided at hospital outpatient clinics. According to OIA, outcome measures for some sectors in the FSM were inappropriate, absent, or poorly defined. The RMI health sector's complex performance hierarchy and lack of readily available baselines for many measures initially made it difficult for the Ministry of Health to collect data. In 2004, JEMCO and JEMFAC required the countries to submit a streamlined and refined statement of performance measures, baseline data, and annual targets to enable the tracking of goals and objectives for education, the environment, health, private sector development and in public sector capacity building.<sup>56</sup> The countries have developed some performance indicators that are intended to help demonstrate progress in education and health, as required by JEMCO and JEMFAC, but have not done so for the other sectors. In 2006, JEMFAC also required the RMI to include in its reports six performance indicators for the environmental sector and two performance indicators for private sector development.<sup>57</sup>

The FSM and the RMI ministries have begun to collect performance indicators for the education and health sectors, as required by JEMCO and JEMFAC. However, the ministries are not yet able to assess progress with the indicators, because baseline data for some indicators were incomplete and the quality of some data was poor.

### FSM Performance Indicators

- *Education sector.* As required by JEMCO, in 2005, the FSM began submitting data for 20 indicators to gauge progress in the education sector. In 2005, the FSM submitted some data for 11 of the 20 required education performance indicators. In 2006, it submitted some data for

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<sup>56</sup>The requirement on public capacity building only applied to the FSM.

<sup>57</sup>Since the reporting requirement was established in 2006 and the data were not available until the end of the fiscal year, in addition, the funding to the two sectors was small compared with the funding to health and education, we did not evaluate these performance measures.

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all of the 20 indicators, with data for 5 indicators being incomplete because some states did not submit them. For example, none of the states submitted data for the number and percentage of high school graduates going to college. Chuuk and Yap did not provide the required average daily student attendance rate, and Kosrae, Pohnpei, and Yap did not provide data to establish a baseline for dropout rates. Furthermore, we found some of the data submitted to be of questionable quality. For example, Chuuk's 2006 submission of data for the 20 indicators indicated a dropout rate of less than 1 percent. However, according to an expert familiar with the Chuuk education system, the actual dropout rate was much higher. Moreover, when comparing the 2005 and 2006 submissions, we identified possible problems with some of the most basic data, such as the number of teachers, students, and schools, due to inconsistent definitions of the indicators. For example, the student enrollment figure reported in 2006 was for public schools only, but the figure submitted in 2005 included both public and private schools, according to an FSM education official. Likewise, reporting on the number of teachers in the school system differed among states. For example, Chuuk reported only the number of teachers, while the other states also included nonteaching staff.

- *Health sector.* FSM state and national health directors agreed on 14 health indicators in April 2006 as a means to gauge progress. The FSM national government and all four states are collecting data for 9 of the 14 indicators, while data for the other 5 indicators have yet to be collected. According to the FSM national government, delays in collecting data for some indicators resulted from the time required to establish a common methodology—that is, definitions and processes—among all of the states and governments. Furthermore, we found that some of the health data collected were ambiguous and therefore difficult to use. For example, it was unclear whether reports on data from Yap's outer islands relating to 1 of the 14 health indicators, the number of dispensary encounters, covered 1 or 2 months; according to a Yap health official, data for this indicator may be incomplete. Likewise, OIA's health grant manager indicated that there are weaknesses in the FSM's health data.
- *Education sector.* As required by JEMFAC in 2005, the RMI started tracking some of the 20 indicators as a way to gauge progress in the education sector. The RMI submitted data for 15 of the 20 required education performance indicators in 2005, repeating the submission in 2006 without updating the data, according to an OIA official. JEMFAC

## RMI Performance Indicators

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required the RMI to submit data for the 5 indicators omitted in 2005—including staff education levels and parent involvement—but did not receive them. In addition, some of the information reported was outdated. For example, the 2005 submission of data for an indicator on student proficiency was based on a test given in the RMI in 2002.

- *Health sector.* The RMI's Ministry of Health began identifying performance indicators when the amended compact entered into force in 2004. Initially, the ministry developed numerous indicators, which, according to an OIA official, threatened to overwhelm the ministry's capacity for data collection and management. The ministry has since made refinements and reduced the number of indicators to a more manageable size. However, according to an RMI government report for 2005,<sup>58</sup> it is difficult to compare the ministry's 2004 and 2005 performances because of gaps in the data reported. For example, limited data were available in 2004 for the outer island health care system and Kwajalein Atoll Health Services. According to the RMI government report, data collection improved and most needed data were available, but some data were still missing.

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### Shortcomings in Performance Reports Limit Usefulness for Tracking Progress

Although the FSM and the RMI began compiling quarterly performance reports beginning in 2004, as required by the fiscal procedures agreements, the usefulness of the reports for assessing progress toward sector goals is limited by several factors. First, the FSM's reports had format problems, such as a lack of uniform structure, and some FSM reports were missing. Second, both countries' reports contained incomplete activity-level information. Third, in both countries' reports, some activity-level information, such as budget and expenditure data, were inaccurate.

- *Problematic format.* The usefulness of the FSM quarterly performance reports is diminished by a lack of uniform structure, excessive length, and disorganization. In addition, some FSM reports were missing. The five FSM governments' quarterly 2005 performance reports that we reviewed lacked the uniform structure required by the fiscal procedures agreement. For example, while Kosrae combined sector and activities into one report, Pohnpei reported on each activity separately. Moreover,

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<sup>58</sup>Republic of the Marshall Islands, Office of the President, Economic Policy, Planning and Statistics Office, *Fiscal Year 2005 Performance Monitoring Report* (Majuro: July 2006).

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the volume of reporting was excessive. For example, the 2005 fourth-quarter reports for the FSM education sector totaled more than 600 pages for all five governments' quarterly submissions and more than 1,500 pages for the entire year. The reports were also disorganized. For example, we found misfiled reports in the FSM's submission to OIA. We also found that 19 sector reports were missing in 2005. Noting shortcomings similar to those we observed, officials from OIA and the FSM stated that the performance reports could not be used as an effective management tool.

In contrast, the RMI reports were uniformly formatted, as specified by the fiscal procedures agreement, and all required reports were submitted to OIA.

- *Incomplete information.* Both countries' quarterly reports lacked complete information on program activities. For example, for 2005, the FSM national government's second-quarter health sector report lacked information on the environmental health and food safety programs (although its other quarterly reports included such information), and Pohnpei's first-quarter health sector report lacked information on 28 of 31 activities. In the fourth quarter of 2005, Kosrae did not provide budgetary and expenditure information regarding the provision of education and support services to individuals with disabilities.

The RMI's statistics office gathered information from the RMI's 2005 quarterly performance reports, which contained primarily activity-level information, and attempted to assess progress in the various sectors. However, because of weaknesses in information collected in 2004, including missing information for some activities for entire quarters, the RMI had difficulty in making comparisons and determining whether progress was being made in many of its sectors.

- *Inaccurate information.* Both the FSM's and the RMI's quarterly performance reports contained inaccurate information on program activities. We found that the performance reports for the five FSM governments did not accurately track or report annual activity budgets or expenditures. For example, a 2005 Pohnpei education performance report stated that more than \$100,000 per quarter was allocated to pay the salaries of two cultural studies teachers. The state's Department of

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Education could not explain the high salary figure<sup>59</sup> but indicated that the number was incorrect. According to FSM officials in the departments we visited, the departments were not given an opportunity to review the budget and expenditure data before the performance reports were sent to OCM and OIA and were therefore unaware of the errors.

Some of the RMI's quarterly performance reports also contained inaccuracies. For example, although the RMI's private sector development performance report for the fourth quarter of 2005 stated that eight new businesses were created in 2005, officials from the Ministry of Resources and Development indicated that only four businesses were started that year. In addition, the RMI Ministry of Health's 2005 fourth-quarter report contained incorrect outpatient numbers for the first three quarters, according to a hospital administrator in Majuro. In the RMI quarterly reports for the education sector, we found several errors in basic statistics, such as the number of students attending school. In addition, RMI Ministry of Education officials and officials in the other sectors<sup>60</sup> told us that they had not been given the opportunity to review final performance reports compiled by the statistics office before the reports' submission to OIA, and that they were unaware of the errors until we pointed them out.

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### FSM and RMI Lack Capacity to Collect, Assemble, and Analyze Data to Assess Progress

The FSM's ability to measure progress is limited by its lack of capacity to collect, assemble, and analyze performance data. According to OIA, the education sector currently lacks a reliable system for the regular and systematic collection and dissemination of information and data. An OCM official also stated that the lack of performance baseline data for the private sector development and environment sectors could be attributable to "weak capacity in performance budgeting and reporting" and that staff lack expertise in one or both areas.

The RMI statistics office, which is the main entity tasked to collect data, indicated that it is not currently able to assess progress toward compact

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<sup>59</sup>According to the FSM National Department of Education, the average annual teacher salary in Pohnpei is approximately \$10,000.

<sup>60</sup>The fiscal procedures agreement requires quarterly construction performance reports in the infrastructure sector. We did not discuss the quality of the information in the reports with the Project Management Unit Manager.

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and development plan goals because of the government's lack of capacity to collect, assemble, and analyze data in all sectors. Likewise, the office's own capacity is limited. Officials from the office emphasized the importance of building capacity in the ministries to evaluate their activities. In particular, they said that improvements in data collection would enable ministries to respond quickly to requests for information from both national and international sources. For example, the officials noted that the Ministry of Education needs to develop measures to report on the quality of education. The officials also noted that other offices in the ministry should hire more trained professionals, such as the recently hired Assistant Secretary of Administration with a graduate degree in public administration.

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## FSM and RMI Provided Limited Monitoring of Grant Operations, and FSM Accountability for Compact Funds Faced Challenges

The FSM's and the RMI's required monitoring of sector grant performance was limited by capacity constraints, among other challenges. In addition, the countries' single audit reports for 2004 and 2005, particularly the FSM's reports, indicated weaknesses in the countries' financial statements and compliance with the requirements of major federal programs, calling into question their accountability for the use of compact funds. However, the FSM's timeliness in submitting its single audit reports improved from 2004 to 2005, and the RMI submitted its single audit reports for these 2 years on time.<sup>61</sup>

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## FSM Provided Limited Monitoring and Accountability for Use of Compact Funds

The FSM's monitoring of sector grant performance, required by the fiscal procedures agreement, was limited at the national and state levels by lack of capacity in the FSM's OCM and in the state governments, among other factors. In addition, the FSM's single audit reports for 2004 and 2005 showed weaknesses in its financial statements and a lack of compliance with requirements of major federal programs, suggesting that the FSM has limited ability to account for the use of compact funds. However, the government's timeliness in submitting its audit reports improved.

## FSM Monitoring

The FSM national government provided limited monitoring of the day-to-day operations of sector grants in 2004 through 2006. In addition to

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<sup>61</sup>OIA requires the countries to submit their single audit reports within 9 months after the end of the fiscal year, which is consistent with the requirements under the Single Audit Act, as amended.

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facilitating coordination and communication between the national government and the states and between the FSM and OIA, OCM is intended to have some responsibility for overseeing compact-funded programs. However, according to the office's director, OCM has neither the staff nor the budget to undertake such activities. As of November 2006, OCM had five of its own professional staff, including the director. Prior to 2007, staff from other FSM national departments were assigned to the office, but only the economic affairs and finance departments provided detailees. One staff was converted to a permanent hire in OCM and it is unclear if the other detailee will remain at OCM or return to the Office of Economic Affairs. The FSM Office of the National Public Auditor had not conducted any performance or financial audits of compact sector grants.<sup>62</sup>

The FSM states, as subgrantees of compact funds, are required to submit performance reports to the FSM national government. However, the Director of OCM indicated that he did not know how or whether each state, other than Chuuk, was set up to perform day-to-day monitoring of sector grants. In Chuuk, a financial control commission was established in July 2005 to address financial management and accountability requirements. However, while the commission had exercised a financial control function, it had not monitored the performance of the sector grants. In addition, the FSM's Secretary of Foreign Affairs and JEMCO representative told us that all of the states were weak on monitoring. Although the states' public auditors could conduct audits of compact performance, their efforts had been limited to financial audits. For example, in both Yap and Pohnpei, the public auditor's office issued four audits in 2005, two of which were for compact-funded activities. Furthermore, in Chuuk, the public auditor position required by the state constitution was not filled, prompting JEMCO to deny the Chuuk auditor's office state-budgeted funds.

## FSM Accountability

The FSM's single audit reports for 2004 and 2005 showed that the FSM's ability to account for the use of compact funds was limited, as shown by weaknesses in its financial statements and lack of compliance with requirements of major federal programs. However, the FSM's timeliness in submitting its audit reports improved during this period.

- *FSM financial statements.* In general, the FSM single audit reports call into question the reliability of the country's financial statements. Of the

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<sup>62</sup>However, the FSM Office of the National Public Auditor conducted an audit related to the FSM's trust fund.

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single audit reports that the FSM national and state governments submitted for 2004 and 2005, only one report—Pohnpei state’s report for 2005—contained an unqualified opinion on the financial statements, while the other reports contained qualified, adverse, or disclaimed opinions.<sup>63</sup> (See app. V for the FSM’s single audit financial statement opinions.) For example, for the FSM 2005 reports, the auditors’ inability to obtain audited financial statements for several subgrantees led them in part to render qualified opinions. Chuuk reports for 2004 and 2005 contained disclaimers of opinion related to seven and eight major issues, respectively, including the inability of auditors to determine the propriety of government expenses, fixed assets, cash, and receivables; the capital assets of one of its subunits; and the accounts payable and expenses of the Chuuk State Health Care Plan. In addition, the single audit reports include specific findings related to the financial statements. For example, the national and state governments’ 2005 single audit reports contained 57 reportable findings of material weaknesses and reportable conditions<sup>64</sup> in the governments’ financial statements, such as the lack of sufficient documentation for (1) the disposal of fixed assets, including a two-story building, and (2) purchases of vehicles and copiers. Fourteen of the FSM 2005 findings had been cited as reportable findings in previous audits.

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<sup>63</sup>“Qualified” opinions state that, except for the effects of the matter to which the qualifications relate, the financial statements are presented fairly, in all material respects. A qualified opinion is given when the auditor finds conditions, such as a lack of supporting evidence or a restriction on the scope of the audit. Scope limitations occur when auditors are not able to perform all of the procedures necessary to conduct audits in accordance with generally accepted auditing standards. Scope limitations can result from the timing of audit work; the inability to obtain sufficient, competent evidential matter; or inadequate accounting records. An auditor issues a “disclaimer” of opinion when unable to perform all of the procedures necessary to complete an audit. In these situations, the audit scope is limited or restricted. A disclaimer of opinion indicates that the reliability of the financial statements is not known, and, in issuing one, the auditor declines to express an opinion on the financial statements. An “adverse” opinion is given when the auditor concludes that the financial statements are not fairly presented.

<sup>64</sup>“Reportable” conditions are matters related to significant deficiencies in the design or operation of internal controls over financial reporting that could adversely affect the entity’s ability to produce financial statements that fairly represent the entity’s financial conditions. Material weaknesses are reportable conditions in which the design or operation of internal controls does not reduce to a relatively low level the risk that errors, fraud, or abuse in financial reporting—that is, material related to the financial statements being audited—may occur and not be detected in a timely fashion by employees in the normal course of performing their duties.

- *FSM compliance with requirements of major federal programs.* Each of the FSM national and state governments' single audit reports for 2004 and 2005 contained qualified opinions on the governments' compliance with requirements of major federal programs, and the 2004 and 2005 reports noted 47 and 45, respectively, total reported weaknesses, on compliance. (App. V shows the FSM single audit reports' total numbers of material weaknesses and reportable conditions regarding compliance with requirements of major federal programs.) Four of the 2005 reports' 45 findings recurred from the 2004 reports. In 2006, the FSM developed corrective action plans that addressed 60 percent of the 2005 audit findings of noncompliance.
- *Timeliness of audits.* The timeliness of the FSM national and state governments' submission of single audits reports improved from 2004 to 2005. The national government submitted its 2004 and 2005 single audits in August and September 2006, 14 and 2 months, respectively, after the due dates. While the four FSM states submitted their 2004 single audits from 7 to 13 months after the due dates, three of the four states submitted their 2005 audits within the 9-month period allowed by OIA.

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## RMI Monitoring Was Limited, but Accountability Improved

The RMI government provided limited monitoring of sector grants, in part because of the lack of capacity in the Chief Secretary's office and in most ministries that receive compact funds. The RMI's single audit reports for 2004 and 2005 indicated weaknesses in its financial statements and compliance with requirements of major federal programs. However, the government developed corrective action plans to address the 2005 findings related to such compliance. The RMI government submitted its single audits for 2004 and 2005 on time.

## RMI Monitoring

The RMI's Chief Secretary, who is responsible for compact implementation and oversight, monitored sector grant operations on a limited basis. Day-to-day monitoring and oversight responsibilities were delegated to the ministries that receive compact funds. According to the RMI's statistical office,<sup>65</sup> it lacked the time and resources to devote to oversight and focused instead on helping the ministries to develop the annual budgets and sector portfolios and the quarterly and annual monitoring and performance reports. The office noted the ministries' lack of personnel and skills needed

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<sup>65</sup>The Economic Policy, Planning and Statistics Office is the RMI's statistics office.

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to collect, assemble, and analyze data and emphasized the importance of building the ministries' capacity to monitor and evaluate their own compact-funded activities. (However, according to an OIA official, the Ministry of Health made important strides in measuring performance and using performance management to improve the delivery of services.) The RMI Auditor General's office conducted financial audits, but no performance audits, of compact sector grants. The RMI, like the FSM, failed to submit its required annual reports in a timely manner.

## RMI Accountability

The RMI's single audit reports for 2004 and 2005 contained opinions and findings that indicated weaknesses in its financial statements and compliance with requirements of major federal programs. However, the government developed a corrective action plan that addressed all of the findings on compliance in its 2005 single audit report. The RMI submitted both of the single audit reports on time.

- *RMI financial statements.* The RMI's single audit reports for 2004 and 2005 contained qualified opinions on the government's financial statements. (See app. V for a list of the opinions on financial statements in the RMI's audit reports for 2001 through 2005.) For example, several of the RMI's subgrantees, such as the Ministry of Education's Head Start program and the Kwajalein Atoll Joint Utilities Resources, Inc., were unable to produce audited financial statements.

In addition, the 2005 single audit found two reportable findings in the RMI's financial statements. The report cited the lack of audited financial statements and the lack of a complete asset inventory listing in the RMI as material weaknesses. Both of these findings had been cited in previous audits.

- *RMI compliance with requirements of major federal programs.* Both of the RMI's single audit reports for 2004 and 2005 contained qualified opinions on the government's compliance with requirements of major federal programs. In addition, the 2005 report noted 11 reported weaknesses in the country's compliance with requirements of major federal programs. The RMI developed corrective action plans to address all of these findings, 2 of which had recurred from 2004. (App. V shows the total number of material weaknesses and reportable conditions findings for the RMI for 2001 through 2005 single audit reports.)
- *Timeliness of audits.* The RMI submitted its 2004 and 2005 single audit reports within the 9-month period required by the Single Audit Act.

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## Interior Took Oversight Actions but Faced Challenges

As administrator of the amended compact grants, OIA monitored the FSM's and RMI's sector grant and fiscal performance, assessed their compliance with compact conditions, and took action to correct persistent shortcomings. However, although OIA provided technical assistance to help the FSM improve its single audit timeliness, the office did not address recurrent findings and adverse opinions in the FSM and the RMI audits. OIA's oversight efforts were hindered by the need to address problems in the FSM and by internal staffing challenges. In addition, Interior's Office of Inspector General actively engaged in reviewing the countries' implementation of the compact, although the office did not release its products to the public, and, as of October 2006, several reports remained in draft form.

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## OIA Monitored Performance, Assessed Compliance, and Acted to Correct FSM and RMI Shortcomings

OIA undertook several administrative oversight efforts including monitoring the countries' sector grant performance, monitoring the countries' fiscal performance and sector grant outlays, and assessing the countries' compliance with sector grant conditions. OIA's efforts also included actions such as suspending or withholding grant payment in response to persistent shortcomings that it identified.

- *Monitoring sector grant performance.* OIA grant managers monitored the countries' sector grant performance, using site visits and analysis of the quarterly sector performance reports. For example, in 2006, OIA's visits and analyses led it to determine that 14 of the 61 offices in the FSM that receive private sector and environment sector grants were underperforming or nonperforming. As a remedy, OIA recommended and JEMCO agreed that future sector funding for these entities should be on a project basis. Also, in response to the shortcomings of the FSM's and RMI's performance evaluations for 2004 and 2005, JEMCO and JEMFAC, under OIA's chairmanship, called for improved performance measurement and monitoring. In the FSM, JEMCO reprogrammed unused compact funds to improve capacity in this area. In addition, in response to recurrent lack of uniformity in the FSM's performance reports, OIA rejected the first-quarter reports for 2006 (although it accepted nonuniform FSM reports later in the year). Although OIA had used the performance reports to monitor sector performance, it was unaware, until we notified the office, that almost 20 percent of the FSM's 2005 performance reports were missing.

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- *Monitoring sector grant outlays and fiscal performance.* OIA monitored the countries' fiscal performance and sector grant outlays through analyses of the countries' quarterly financial reports and, as Chair of JEMCO and JEMFAC, through reviews of the countries' single audit reports. In August 2004, OIA analyses of both countries' third-quarter cash transactions reports showed that some sector grant funding had not been spent. In response, OIA delayed payments to the FSM and the RMI for those sectors.
  - *Reviewing single audit reports.* As Chair of JEMCO and JEMFAC, OIA led the committees' reviews of, and responses to, the FSM's and the RMI's single audit reports. At a March 2006 JEMCO meeting, noting that single audits were the most important indicator of financial stability provided by a grantee to a grantor, OIA's Director of Budget and Grants Management said that OIA intended to "apply a remedy" for single audit noncompliance beginning October 1, 2006, if the FSM failed to complete all of its audit reports by July 1, 2006, or within 3 months of the due date. The Director stated that OIA's response would include withholding cash payments for various grants not related to the provision of medical care, emergency public health, or essential public safety. The Director also stated that OIA would notify and seek the concurrence of other U.S. agencies providing financial and technical assistance in designating the FSM a "high-risk grantee." Three FSM states met OIA's July 1 deadline, while the national government and Chuuk missed the deadline by 2 and 1 months, respectively. OIA ensured that the FSM received technical assistance to help address its single audit reports' lack of timeliness, placing advisors through a third party in the state governments to facilitate their completion of overdue reports. In 2004, we recommended that OIA initiate appropriate actions to correct compact-related single audit findings and respond to violations of grant conditions or misuse of funds identified by single audits.<sup>66</sup> Since then, OIA has provided technical advice and assistance to help the FSM and the RMI improve the quality of their financial statements and develop controls to resolve audit findings and prevent recurrences.
  - *Assessing compliance with grant conditions.* OIA assessed the FSM's and the RMI's compliance with sector grant conditions through site visits to the countries and reviews of the countries' submitted

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<sup>66</sup>GAO, *Compact of Free Association: Single Audits Demonstrate Accountability Problems over Compact Funds*, GAO-04-7 (Washington, D.C.: Oct. 7, 2003).

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paperwork. In certain instances of the FSM's or the RMI's noncompliance with grant conditions, OIA monitored progress toward meeting the requirements and allowed the countries more time, while in other instances, OIA did not specifically address FSM or RMI noncompliance. (See apps. VI and VII for a list of sector grant special terms and conditions and their status.) However, OIA took corrective actions in several instances.

- *Suspended grant funding.* In December 2004, OIA staff conducting a site visit were unable to verify that food purchased by the program had been received by the Chuuk Education Department or served to students. In response, OIA suspended the Chuuk 2005 education grant's meal service program funding of almost \$1 million. OIA contacted Interior's Office of Inspector General for a follow-up investigation to determine whether Chuuk was misusing compact funds.
- *Withheld grant funding.* OIA withheld the FSM's May and June 2004 public sector capacity building and private sector development grant funding—approximately \$2.4 million—when the FSM national government missed a March 2004 deadline to provide a transition plan for ending nonconforming use of the grant. In addition, OIA withheld awarded funds for the FSM infrastructure grant and the RMI Kwajalein special needs grant until the countries met grant terms.

After our July 2005 report, which recommended that OIA determine the amount of staff travel to the FSM and the RMI needed to promote compliance with compact and grant requirements, OIA travel to the countries increased.<sup>67</sup> Whereas travel to the two countries accounted for 15 percent of overall staff time in 2004, it rose to 20 percent in 2005 and 25 percent for the first three quarters of 2006. However, according to an OIA assessment, OIA's current budget does not support extended, detailed reviews of U.S. funds in the various remote islands.

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## OIA Oversight Faced Challenges

OIA's oversight was hampered by the need to respond to problems in the FSM as well as by the office's difficulty in filling staff positions.

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<sup>67</sup>GAO-05-633.

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- *FSM challenges.* The need to respond to various challenges facing the FSM reduced OIA's administrative oversight of assistance provided under the compact. According to the Director of OIA, the FSM's budgets for 2005 through 2007 were poorly prepared, and, as a result, OIA grant managers were forced to spend an inordinate amount of time readying the budgets for the JEMCO meetings. In addition, according to OIA's Director of Budget and Grants Management, the constant need to respond to emergent issues, such as education issues in Chuuk and land issues in the FSM, limited OIA's ability to conduct oversight.
  - *Staffing challenges.* Although OIA increased the 2006 budget for the Honolulu field office so that it could increase the number of staff positions, those new positions remained vacant. In December 2005, an advertised position to be based in Guam went unfilled, while an education grant specialist position in Honolulu was advertised twice after April 2006 but remained vacant for the entire fiscal year. In addition, the OIA private sector development and environment specialist position became vacant in September 2006.

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### Interior's Inspector General Reports Identified Problems but Were Not Published

Interior's Office of Inspector General undertook compact oversight activities, finding deficiencies in the FSM's and the RMI's compact implementation and accountability.<sup>68</sup> In 2005 and 2006, the Inspector General conducted six reviews (three remained in draft form as of October 2006) addressing issues such as

- environmental and public health concerns in Chuuk (draft dated June 2005),
- student meal programs in Chuuk (draft dated June 2005),
- the RMI's progress in implementing the amended compact (final report issued August 2005),
- the FSM's progress in implementing the amended compact (draft dated January 2006),

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<sup>68</sup>The Inspector General also has undertaken an investigation in Chuuk regarding the education meal service program.

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- the FSM's infrastructure grant implementation (final report issued July 2006), and
  - the FSM's compact trust fund status (final report issued July 2006).

Although the Inspector General distributed the three final reports to OIA and the FSM and the RMI governments, the final reports were not released to the public or disseminated widely in the FSM and the RMI. However, one of the draft reports circulated unofficially and was cited by the media. According to the Inspector General, the reports are considered advisory in nature and, as such, no specific response is required from OIA regarding the recommendations. Nonetheless, OIA officials stated that the office has found the recommendations useful and has made an effort to address them.

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## Conclusions

Since enactment of the amended U.S. compacts with the FSM and the RMI, the two countries have made significant efforts to meet new requirements for implementation, performance measurement, and oversight. However, in attempting to meet these requirements, both countries face significant challenges that, unless addressed, will hamper the countries' progress toward their goals of economic advancement and budgetary self-reliance before the annual grant assistance ends in 2023.

In 2004 through 2006, compact grants were, for the most part, allocated among the countries' six sectors as required, with emphasis on health, education, and infrastructure, and the countries have made progress in implementing the grants in most sectors. However, despite the revenue shortfalls they will face with the scheduled grant decrements, neither nation has concrete plans to raise the funds needed to maintain government services in the coming years. Furthermore, although the FSM's allocation of funds among the states and among sectors caused significant inequalities in per-student support for education and per-capita funding for health care, neither the FSM nor JEMCO evaluated the impact of these differences on the country's ability to meet national goals or deliver services.

Furthermore, although the countries worked to develop the sector grant performance indicators required by JEMCO and JEMFAC, a lack of complete and reliable baseline data limited the countries' use of the indicators to measure performance and evaluate progress. Moreover, weaknesses in the countries' required quarterly performance reports—including missing and, in some cases, inaccurate activity

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data—limited the reports’ usefulness. Unless the FSM and the RMI take steps to correct these weaknesses in performance measurement, their ability to use the sector grants to optimal effect will continue to be curtailed.

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## Recommendations for Executive Action

Given the FSM’s and the RMI’s need to maximize the benefits of compact assistance before the 2023 expiration of annual grants and to make steady progress toward the amended compact goals, we are providing the following seven recommendations to the Secretary of the Interior.

To improve FSM grant administration, planning, and measurement of progress toward compact goals, and to ensure oversight, monitoring, and accountability for FSM compact expenditures, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of JEMCO, to coordinate with other U.S. agencies on the committee in working with the FSM national government to take the following actions:

- establish plans for sector spending and investment by the FSM national and state governments to minimize any adverse consequence of reduced funding resulting from the annual decrement or partial inflation adjustment;
- evaluate the impact of the current FSM distribution between states and sectors on the ability of the nation to meet national goals or deliver services;
- fully develop the mechanism for measuring sector grant performance and collect complete baseline data to track progress toward development goals; and
- ensure that the quarterly performance reports contain reliable and verified program and financial information for use as a monitoring tool by both the FSM and the U.S. governments.

To improve RMI grant administration, planning, and measurement of progress toward compact goals, and to ensure oversight, monitoring, and accountability for RMI compact expenditures, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of JEMFAC, in coordination with other U.S. agencies

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on the committee in working with the RMI government to take the following actions:

- establish plans for sector spending and investment that minimize any adverse consequence of reduced funding resulting from the annual decrement or partial inflation adjustment;
- fully develop the mechanism for measuring sector grant performance and collect complete baseline data to track progress toward development goals; and
- ensure that the quarterly performance reports contain reliable and verified program and financial information for use as a monitoring tool by the RMI and the U.S. governments.

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## Agency Comments and Our Evaluation

We received comments from the Department of the Interior as well as from the FSM and the RMI (see app. VIII through X for detailed presentations of, and our responses to, these comments). We also received technical comments from the Departments of Education, Health and Human Services, and State, which we incorporated in our report as appropriate.

Interior concurred with our recommendations and stated that the report was accurate and well balanced. The FSM also viewed the report as a balanced and fair assessment of its progress in planning for sustainability, measuring progress, and ensuring accountability and agreed with our overall conclusion that it faces significant challenges in meeting the various amended compact requirements. The FSM, however, defended its distribution formula for allocating compact funds to the national and state governments. The RMI acknowledged that its lack of capacity has slowed its implementation of the compact's monitoring and reporting requirements. The RMI also stated that it has refrained from expanding ministry staffs, given the need for budgetary restraint.

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

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will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions regarding this report, please contact me at (202) 512-3149 or [gootnickd@gao.gov](mailto: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 XI.

A handwritten signature in black ink, appearing to read "David Gootnick". The signature is stylized with a large, looping initial "D" and a cursive "Gootnick".

David Gootnick  
Director, International Affairs  
and Trade

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*List of Committees*

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

The Honorable Richard G. Lugar  
Chairman  
The Honorable Joseph R. Biden, Jr.  
Ranking Minority Member  
Committee on Foreign Relations  
United States Senate

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

The Honorable Henry J. Hyde  
Chairman  
The Honorable Tom Lantos  
Ranking Minority Member  
Committee on International Relations  
House of Representatives

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# Objectives, Scope, and Methodology

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This report examines, for 2004 through 2006,<sup>1</sup> (1) the Federated States of Micronesia's (FSM) and the Republic of the Marshall Islands' (RMI) use of compact funds; (2) FSM and RMI efforts to assess progress toward their stated development and sector goals; (3) FSM and RMI monitoring of sector grants and accountability for the use of compact funds; and (4) the Department of the Interior's (Interior) administrative oversight of the compacts. Appendix II contains information about activities funded by key U.S. programs.

To report on the FSM's and the RMI's use of amended compact funds, we reviewed the U.S., FSM, and RMI annual compact reports for 2004 and 2005; FSM and RMI strategic planning documents and budgets; briefing documents prepared by Interior's Office of Insular Affairs (OIA) in preparation for the annual bilateral meetings with the two countries; and FSM and RMI single audits for 2001 through 2005. We reviewed all 2004, 2005, and 2006 grant agreements with both countries obtained from OIA, including special terms and conditions included in these agreements.<sup>2</sup> We compared and analyzed fund uses with the purposes specified in the amended compacts, the implementing legislation, subsidiary fiscal procedures agreements, and sector grant special terms and conditions.

To identify issues that impact the use of compact funds, we discussed planning efforts with U.S., FSM, and RMI government officials and identified issues through our own analysis that affected planning, such as the FSM's use of its distribution formula. We reviewed relevant documents such as FSM and RMI legislation, and we also reviewed documentation provided to the U.S. government, such as the FSM's transition plan to eliminate the nonconforming spending under the public sector capacity building grant. To compute education spending per student, we used FSM and RMI grant data and student and population statistics. To calculate the variability in health spending per capita across the four FSM states, we used FSM grant data and population statistics. We did not calculate health spending per capita for the RMI. We determined that these data were sufficiently reliable for the purposes of our report.

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<sup>1</sup>In this report, all annual references refer to the fiscal year rather than the calendar or school year, unless otherwise stated.

<sup>2</sup>We did not review funding provided to Kwajalein landowners in exchange for U.S. military access to Kwajalein Atoll. This funding is for landowner use and is not included as part of U.S. economic assistance that is subject to sector grant and accountability requirements.

Although we were asked to evaluate the effectiveness of the compact funds, we determined it was too soon after the amended compacts' implementation to do this; therefore, we report on whether the countries are able to measure progress. To identify FSM and RMI efforts to assess progress toward their stated goals, we reviewed FSM and RMI strategic planning documents. We evaluated the framework in place for the FSM and the RMI to measure the achievement of stated goals in strategic planning documents and compared them with the countries' budget and quarterly performance documents. To determine whether the quarterly performance reports were being used as a tool to measure progress, we analyzed quarterly performance reports for 2005 consistently across five sectors and the accuracy of the budget information.<sup>3</sup> We then verified the results of our analyses with each office or department we interviewed in the FSM and the RMI in March and April 2006. We asked if they used these reports to measure progress and discussed discrepancies we found in the reports. To identify obstacles to measurement and achievement of goals, we reviewed the U.S. annual compact reports for 2004 and 2005, FSM and RMI annual compact reports for 2004 and 2005, FSM and RMI strategic planning documents and budgets, U.S. government briefing documents, and the RMI's 2005 Performance Monitoring Report. We verified this information with FSM, RMI, and OIA officials.

To identify the extent to which the FSM and RMI governments conducted monitoring and accountability activities, we reviewed the amended compacts and fiscal procedures agreements to identify specific monitoring responsibilities. We also reviewed the U.S. government briefing documents, as well as the minutes and resolutions, when available, that were related to the Joint Economic Management Committee (JEMCO) and Joint Economic Management and Financial Accountability Committee (JEMFAC) meetings. We further reviewed FSM and RMI documents—such as budget justifications and portfolios, quarterly performance reports, and annual financial reports for 2004 through 2006, as available—submitted by the FSM and RMI governments to the U.S. government to confirm compliance with accountability reporting requirements. We discussed the sufficiency of quarterly performance reports with OIA officials. We obtained the single audit reports for 2001 through 2005 from the FSM National Auditor's Web

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<sup>3</sup>We did not assess the infrastructure sector performance reports for this purpose. In the FSM, no infrastructure sector reports were available at the time of our review because no infrastructure projects had been built. In the RMI, construction performance reports were available, although they served a different purpose than the quarterly performance reports in other sectors.

site and the RMI's Office of the Auditor General. These reports included audits for the FSM national government; the state governments of Chuuk, Kosrae, Pohnpei, and Yap; and the RMI national government. In total, the 30 single audit reports covered 5 years, a period that we considered sufficient for identifying common or persistent compliance and financial management problems involving U.S. funds. We determined the timeliness of submission of the single audit reports by the governments using the Federal Audit Clearinghouse's (FAC) "Form Date," which is the most recent date that the required SF-SAC data collection form<sup>4</sup> was received by the FAC. We noted that the Form Date is updated if revised SF-FACs for that same fiscal year are subsequently filed. Our review of the contents of the single audit reports identified the auditors' opinions on the financial statements, matters cited by the auditors in their qualified opinions, the numbers of material weaknesses and reportable conditions reported by the auditors, and the status of corrective actions. We did not independently assess the quality of the audits or the reliability of the audit finding information. We analyzed the audit findings to determine whether they had recurred in successive single audits and were still occurring in their most recent audit, and we categorized the auditors' opinions on the financial statements and the Schedules of Expenditures of Federal Awards.

To determine oversight activities conducted by the OIA Honolulu office, we reviewed senior management statements regarding the purpose and function of this office and job descriptions for all staff. To identify the extent that the Honolulu office staff traveled to the FSM and the RMI, we obtained the travel records for all program specialists and discussed this information with OIA officials to ensure that these data were sufficiently reliable for our use. We calculated the percentage of time spent conducting on-site reviews in the two countries between 2004 and the third quarter of 2006 and compared these data with the total available work time for the program specialists.

In addition, to report on the FSM's and the RMI's use of noncompact federal funds, we updated our prior review of U.S. programs and services that GAO issued in 2002.<sup>5</sup> The prior review selected 13 programs and services, including those with the largest expenditures and loans over a 15-year

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<sup>4</sup>The FSM and the RMI governments submit a SF-SAC data collection form to the FAC that includes information about the auditee, its federal programs, and the results of the audit.

<sup>5</sup>GAO, *Foreign Assistance: Effectiveness and Accountability Problems Common in U.S. Programs to Assist Two Micronesian Nations*, GAO-02-70 (Washington, D.C.: Jan. 22, 2002).

period, as well as each of the services that the U.S. government agreed to provide under the compact.<sup>6</sup> Funding for 3 of these programs was consolidated into the Supplemental Education Grant under the amended compacts and was excluded from this update.<sup>7</sup> Moreover, to report on OIA-awarded technical assistance and operations and maintenance improvement program grants, we selected several projects that assisted compact implementation or complemented sector grant priorities, such as education and health, from among grants awarded to the FSM and the RMI for 2004 and 2005. We also requested applications and grant evaluation information for these projects from OIA. To determine the total amount of noncompact federal funding that the FSM received from the United States, we used the schedule of expenditures of federal awards from the 2004 and 2005 single audit reports of the FSM national government, the four FSM states, and the College of Micronesia to calculate total FSM expenditures. For the FSM national government expenditure total, we included only direct expenditures and did not include funds that were passed from the national government to the states. We compiled the expenditure amounts passed directly to the four states from each of the state's respective single audit reports and combined these states totals and the national government totals to obtain the total FSM expenditure amount. We excluded compact and amended compact expenditures from our calculation. For the RMI, the federal awards section of the RMI and College of the Marshall Islands 2004 and 2005 single audit reports was used to calculate total RMI expenditures. The amount of compact funding for the FSM and the RMI was compared with the total amount of federal expenditures for 2004 and 2005 to get the percentage of noncompact U.S. federal funding.

To address all of our objectives, we held interviews with officials from Interior (Washington, D.C.; Honolulu, Hawaii; the FSM; and the RMI) and the Department of State (Washington, the FSM, and the RMI). We also

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<sup>6</sup>These programs were (1) Head Start, (2) Special Education Program for Pacific Island Entities, (3) Freely Associated States Education Grants, (4) Pell Grants, (5) Job Training Partnership Act, (6) Maternal and Child Health Block Grants, (7) U.S. Department of Agriculture's Rural Housing Service housing loans, (8) U.S. Department of Agriculture's Rural Utilities Service Telecommunications loans, (9) U.S. Department of Agriculture's Rural Utilities Service Electrical loans, (10) Federal Emergency Management Agency, (11) U.S. Postal Service, (12) Federal Aviation Administration, and (13) U.S. National Weather Service.

<sup>7</sup>The three programs were (1) Head Start; (2) Freely Associated States Education Grants; and (3) job training for adults (Job Training Partnership Act), later known as the Workforce Investment Act.

interviewed officials from the Departments of Health and Human Services (Washington and Honolulu); Education (Washington; San Francisco, California; and Seattle, Washington); and Agriculture (Washington, Honolulu, and Guam); the Federal Aviation Administration (Honolulu); the National Weather Service (Honolulu); the Federal Emergency Management Agency (FEMA) (San Francisco and Honolulu); and the U.S. Postal Service (Honolulu). We traveled to the FSM (Chuuk, Kosrae, Pohnpei, and Yap) and the RMI (Arno, Kwajalein, and Majuro Atolls). In addition, in Chuuk, we visited the islands of Fanapangas, Fefan, Polle, Toll, Tonoas, Udot, Uman, Ut, and Weno. In both countries, we visited primary and secondary schools, colleges, hospitals, dispensaries and community health centers, farms, fisheries, post offices, weather stations, telecommunication offices, and airport facilities. We discussed compact implementation with the FSM (the national, Chuuk, Kosrae, Pohnpei, and Yap governments) and the RMI officials from foreign affairs, finance, budget, health, education, public works, and audit agencies. Furthermore, we met with the RMI's Chief Secretary and the FSM's Office of Compact Management. In Kwajalein Atoll, we also met with officials from the U.S. Army Kwajalein Atoll and Ebeye's Mayor, with its Ministry of Finance, and with the public utility and health and education officials to discuss compact implementation issues. We met with a representative from the FSM's Micronesia Seminar, a nonprofit organization in Pohnpei that provides public education on current FSM events, to obtain views on compact implementation and development issues. We also observed 2005 and 2006 JEMCO and JEMFAC meetings. We met with officials from Interior's Office of Inspector General (Guam, Honolulu, and Washington) to discuss ongoing investigations in the FSM and the RMI.

We conducted our review from October 2005 through December 2006 in accordance with generally accepted government auditing standards. We requested written comments on a draft of this report from the Departments of the Interior, State, and Health and Human Services as well as the governments of the FSM and the RMI. All of these entities' comments are discussed in the report and are reprinted in appendixes VIII through X. In addition, we considered all technical comments and made changes to the report, as appropriate.

# U.S. Program Assistance to the FSM and the RMI

In addition to compact funding, both the FSM and the RMI received approximately 30 percent of their total U.S. expenditures during 2004 and 2005 from other federal agencies, including the Departments of Agriculture, Education, Health and Human Services, and Transportation. As part of the amended compacts' subsidiary agreements with the RMI and the FSM, the United States agreed to extend and subsidize essential federal services, such as weather, aviation, and postal services that were provided under the original compact. The amended compacts also extend the programs and services of FEMA to the FSM and the RMI, but only until December 2008. At that time, responsibility for disaster assistance in the countries is transferred from FEMA to the United States Agency for International Development.<sup>1</sup>

U.S. program assistance is authorized by various sources, including the amended compacts and their implementing legislation as well as other U.S. legislation.

Table 3 shows the amount of noncompact U.S. program funds expended on the FSM and the RMI for 2004 and 2005. Details of several key U.S. programs<sup>2</sup> follow in tables 4 through 14.

**Table 3: Noncompact U.S. Program Fund Expenditures for the FSM and the RMI, 2004 and 2005**

Dollars in millions		
Country	2004	2005
FSM	\$32.2	\$39.0
RMI	11.0	11.8

Sources: Single audit reports 2004 and 2005 from the FSM and the RMI.

<sup>1</sup>Both countries expressed concerns with this transfer since FEMA had provided extensive aid to both countries, such as the \$12.3 million in assistance to the FSM in 2004 after typhoon Sudal hit Yap in April 2004.

<sup>2</sup>These programs were reviewed in a previous GAO report on U.S. program assistance to the FSM and the RMI. See [GAO-02-70](#). Three of these programs have been incorporated into the Supplemental Education Grant and are no longer under the direct oversight of the individual federal agencies. These programs were (1) Head Start, (2) the Freely Associated States Educational Grant Program, and (3) the Job Training and Partnership Act Program. We reviewed the remaining 10 programs and added a review of the OIA Technical Assistance and Operations and Maintenance Improvement program for a total of 11 programs.

**Appendix II  
U.S. Program Assistance to the FSM and the  
RMI**

**Table 4: Department of the Interior OIA Technical Assistance and Operations and Maintenance Improvement Program Grants**

Dollars in millions

Purpose and legislation	<p>The FSM and the RMI continue to be eligible for the discretionary grant program of the Department of the Interior's (DOI) Office of Insular Affairs (OIA), which provides both general technical assistance grants and the operations and maintenance improvement program (OMIP) grants. The legislative authority for these activities is found at 48 U.S.C. 1469d. According to OIA, the technical assistance program provides support not otherwise available in areas where expertise is lacking in the FSM and the RMI. The program allows each government to identify pressing needs and priorities and to develop plans of action to mitigate these problems. OIA reported that many of the technical assistance projects have a direct relationship to improving accountability and performance requirements under the amended compact. OMIP grants are designed to create and support institutions that enhance the capability of the governments of the FSM and the RMI to maintain their capital infrastructure. Specific areas that OIA has targeted for OMIP assistance are water, sewage, or power systems; solid waste disposal; roads; ports; airports; schools; and other public buildings.</p>	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	FY2004: \$1.54 FY2005: \$2.33	FY2004: \$0.98 FY2005: \$2.22
Use of funds	<p>In the FSM, the technical assistance (TA) program funded about 40 projects, of which 21 were OMIP grants in 2004 and 2005. The TA grants supported more FSM governmentwide projects, while the OMIP grants were, in most cases, for specific projects within individual states. OIA stated that many of the TA projects have a direct relationship to improving accountability and performance requirements under the amended compact. For example, they provided training funds for the Public Auditor's Offices, and funded a project to evaluate the overseas medical referral program, which was requested by the FSM Department of Health. Another TA project was to assist the College of Micronesia with its budgeting, long-term planning, and decision making through the hiring of a consultant.</p> <p>Operations and maintenance projects were funded in each of the four states. For example, projects in Kosrae were for power plants and prepayment electric meters; in Pohnpei, for the Port Authority and Pohnpei State campus; in Yap, to assist the state college; and in Chuuk, to provide equipment and software for the public utility corporation.</p> <p>In the RMI, the TA program funded about 35 projects, of which 8 were OMIP grants in 2004 and 2005. OIA stated that many of the projects have a direct relationship to improving accountability and performance requirements under the amended compact. For example, they provided training funds for the Public Auditor's Office, including the training of interns in accounting and computer operations. In addition, TA grants supported several large projects, such as purchasing a new computer system to improve border controls and enhance tax collection and customs programs, developing and implementing a performance-based budgeting process, and installing geographic information systems for support of economic development and landownership. OIA also funded a series of TA grants to assist and assess the College of the Marshall Islands accreditation project.</p> <p>The operations and maintenance projects also focused on addressing changing conditions that allow poor maintenance practices to exist and not just on making repairs. Examples of operations and maintenance projects were the writing of a landfill operations manual, a recycling and collection project, a project to improve the Majuro hospital, and assistance to the Kwajalein Atoll Joint Utilities Resource apprenticeship and management projects.</p>	

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**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

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*(Continued From Previous Page)*

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Dollars in millions

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Program observations	OIA has conducted limited oversight over its TA program. OIA's Financial Assistance Manual states that OIA field staff should conduct on-site surveys or meet periodically with the program manager and submit a <i>Report of Grant Site Visit</i> form to the grant manager. However, we found that the OIA Technical Assistance Division did not have any reports of visits by either OIA's field staff or OIA grant managers who conducted monitoring activities on behalf of the TA division for any of the projects we selected for review. A lack of staffing and insufficient travel funds between 2004 and 2006 were reasons given by the Director of the TA division for the limited oversight activity of his office. We found, once projects were funded, there was little follow-up or evaluation of the projects. For example, we reviewed the consulting grant for the FSM's and the RMI's community college accreditation efforts and found that, in the FSM, the consultant never finished or delivered her report and that OIA never asked for a final product or report. In the RMI, the consultant completed an inferior product that was rejected by the College of the Marshall Islands Board and had to be redone by another consultant. According to RMI officials, some more ambitious projects, such as enhancing the income revenue of the tax division within the RMI, could not be completed within the time frames and funding levels that were allocated and an additional grant would be needed to complete the project. The TA grant manager said that he has started to ask the OIA Honolulu field staff to check on specific TA projects if he knows that staff will be traveling to a particular state or country.
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Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

**Table 5: Department of Education Individuals with Disabilities Education Act/Special Education Program for Pacific Island Entities**

Dollars in millions

**Purpose and legislation** The Special Education Program for Pacific Island Entities (SEPIIE) was a competitive direct grant program, provided by the Department of Education (DOE), to support special education and related services to children with disabilities aged 3 through 21 years, as authorized under the 1997 Individuals with Disabilities Education Act (IDEA), as amended (Pub. L. No. 91-230). According to an official from the Office of Special Education Programs, following the Individuals with Disabilities Education Improvement Act of 2004 (Pub. L. No. 108-446), SEPIIE was phased out, and the FSM and the RMI began to receive grants under the IDEA Special Education Program applicable to the 50 states and the outlying areas. The official also stated that during the transition, the FSM and the RMI received both SEPIIE and IDEA grant funding for use in 2005 and that the doubling of funding was a one-time event, and funding beginning in 2006 came only from IDEA.

	<b>U.S./FSM</b>	<b>U.S./RMI</b>
<b>Funding</b>	SEPIIE FY2004: \$3.89 FY2005: \$3.89 IDEA FY2005: \$3.89 FY2006: \$3.89	SEPIIE FY2004: \$1.73 FY2005: \$1.73 IDEA FY2005: \$1.73 FY2006: \$1.73

**Use of funds** According to FSM's Grant Performance Report, 2,464 FSM students received special education services during the 2004-2005 school year, representing approximately 7 percent of the students enrolled in public schools in the four FSM states.

According to the school year 2004-2005 Grant Performance Report, special education services are provided to 847 students, or approximately 10 percent of the students enrolled in RMI public schools. These services were available on all 24 inhabited atolls and in 72 of the 78 public elementary schools, as well as in all 4 public high schools.

The FSM had 176 special education instructors, of which at least 40 percent were not fully certified, in 2005. According to a FSM Special Education official, the FSM Special Education Program requires the states to collect teacher certification data quarterly. In addition according to a U.S. Special Education official, the IDEA program requires that all instructors have at least a Bachelor of Arts (BA) degree. To support this effort, a FSM special education official said that the FSM's Special Education Program has allocated funding for 63 instructors to attain BAs with funding that will be available through 2007.

Special education services were provided by 108 special education teachers and 4 support staff funded by SEPIIE. Of the 108 teachers, 2 have BA degrees, 38 have Associate of Arts or Science degrees, and the remaining 68 have high school degrees or less. The Ministry of Education has set December 2008 as its goal for ensuring that all of its teachers have at least an Associates Degree. However, according to an official from the Office of Special Education Programs, the requirement for the IDEA program is for all instructors to have at least a BA. Under IDEA requirements the RMI's first Annual Performance Report on meeting its targets is due to the U.S. Office of Special Education Programs by February 7, 2007, and so the status of this requirement will not be available until that date.

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**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

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*(Continued From Previous Page)*

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Dollars in millions

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Program observations      Each country's programs support the objectives of (1) providing direct special education and related services for eligible children with disabilities and (2) building the capacity to provide improved special education in the future by, for example, providing teacher training and training for therapists in these programs, while also improving facilities and service delivery through the use of vehicles such as buses and boats. However, according to FSM and RMI education officials progress toward achieving these goals has been slow, since (1) both countries' school systems are staffed by a substantial number of underqualified teachers and (2) both countries lack skilled support personnel, such as audiologists, diagnosticians, speech pathologists, and physical therapists. However, the countries have better addressed their goal of increasing parental involvement, since both the FSM and the RMI have active organizations for parents of children with disabilities.

DOE's oversight has been indirect, as the Washington, D.C.-based program officer from the Office of Special Education has never visited the countries. However, that official noted that DOE provides technical assistance and staff training to country special education staff through meetings and conferences held in the United States. The official also said that the office plans to make site visits to both countries in October 2006 as part of DOE's review of all education programs and, in 2007, intends to again visit the countries and meet with teachers in schools. The office believes it does monitor the Special Education Programs in both countries, but limited travel funds and the high cost of travel to the FSM and the RMI were noted as constraints on oversight.

During the annual single audits of federally funded programs in the FSM and the RMI, both countries' Special Education Programs were found to have problems complying with federal regulations, such as not adequately documenting procurement procedures and failing to report financial status or track property purchased with federal funds; in addition, the FSM has not submitted its audits in a timely manner. For example, both the FSM's and the RMI's 2004 single audits documented problems with special education program procurement. Since the U.S. Special Education Program Office has not been able to visit each country because of limited travel funds, its use of the single audit is especially critical. However, the FSM's late submission of its single audits hinders this effort.

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Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
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**Table 6: Department of Education Pell Grant Program**

Dollars in millions

Purpose and legislation	Pell Grants, from the Department of Education (DOE), are intended to provide eligible, undergraduate students with financial assistance for educational expenses. The Higher Education Act of 1965, as amended (Pub. L. No. 89-329), authorized the FSM's and the RMI's participation.	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	FY2004: \$7.93 FY2005: \$8.20 FY2006: \$7.02 <sup>a</sup>	FY2004: \$2.15 FY2005: \$2.21 FY2006: \$1.55 <sup>a</sup>
Use of funds	<p>For 2005, Pell Grants provided approximately 2,560 FSM students with grant assistance to attend the College of Micronesia.</p> <p>Furthermore, approximately 1,200 additional FSM residents received Pell Grants to attend colleges and universities in the United States. The funding that these students received is not included in the funding listed above.</p> <p>College of Micronesia officials said that Pell Grants are a critical source of funds for their college—they represented 45 percent of the college's operating expenditures in 2005.</p>	<p>For 2005, Pell Grants provided approximately 820 RMI students with grant assistance to attend the College of the Marshall Islands.</p> <p>Furthermore, approximately 260 additional RMI residents received Pell Grant assistance to attend colleges and universities in the United States. The funding that these students received is not included in the funding listed above.</p> <p>College of Marshall Island officials said that Pell Grants are a critical source of funds for their college, providing about 43 percent of all federal award expenditures at the college for 2005.</p>
Program observations	<p>The Pell Grant Program provides grants to eligible FSM and RMI students, and, because of the low-income levels in the two countries relative to the United States, most students qualify for the program. One major problem students from both countries face is a lack of adequate primary and secondary school training to prepare them for college-level courses. For example, a June 2005 briefing paper by the RMI Ministry of Education, cosponsored by the Asian Development Bank, showed the vast majority of high school graduates entering the College of the Marshall Islands from 2002 to 2004 qualified only for remedial courses. In math, very few students qualified for credit courses, while over half of the students did not even qualify for remedial courses. FSM College of Micronesia officials also stated that because of the inferior primary and secondary school preparation at most of the schools on the islands, most students do not pass the entrance exam to come to the national campus. The Pell Grant training officer said that students could take up to 30 credits of classes of remedial coursework and needed English as a Second Language (ESL) classes under the Pell Grant. However, students often use up all of their remedial course allotment and still need a significant amount of ESL courses before they are even able to begin taking the credit classes needed to eventually attain a degree.</p> <p>According to a DOE Institutional Review Specialist, the U.S. Federal Student Aid Office annually reviews the single audits of the colleges in both countries and issues a final audit determination letter to each institution. The office had advised the College of the Marshall Islands in its letters to the institution from 2000 through 2004 that repeat findings or failure to resolve audit findings may lead to an adverse administrative action, which could include the imposition of a fine or the limitation, suspension, or termination of the eligibility of the institution to receive funds. However, according to a DOE Institutional Review Specialist, the number of audit findings and the number of recurring findings had decreased between 2000 and 2004 for the RMI, and that the FSM had no findings in the 2002 and 2003 audit letters. Moreover, the fiscal year 2005 single audits of the College of Micronesia and the College of the Marshall Islands gave unqualified "clean" opinions on their financial statements and listed no auditor findings; the FSM had no questioned costs and the RMI had about \$239,000 in unresolved questioned costs from the previous year's audits.</p>	

Sources: GAO analysis of documents and interviews with agency officials.

<sup>a</sup>As of August 2006. Schools have until October 2, 2006, with a few exceptions, to submit Pell Grant payments.

**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

**Table 7: Department of Health and Human Services Maternal and Child Health Block Grants Program**

Dollars in millions

Purpose and legislation	The Maternal and Child Health (MCH) Block Grants Program under the Department of Health and Human Services (HHS), was authorized by Title V of the 1935 Social Security Act, as amended (49 Stat. 620). MCH was intended to help states provide mothers and children with access to quality health services and to reduce infant mortality and the incidence of preventable diseases. In 1981, MCH, along with several other categorical programs, was converted to a block grant, which allowed states to implement the program with maximum flexibility and minimum reporting requirements.	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	FY2004: \$0.56 FY2005: \$0.56 FY2006: \$0.53	FY2004: \$0.25 FY2005: \$0.25 FY2006: \$0.24
Use of funds	The MCH program in the four FSM states provided significant direct health care and implementing services for the maternal and infant population. In 2004, the FSM MCH program reported providing services to 61,091 eligible mothers and children, and fully immunizing nearly 43 percent of the 19- to 35-month-old children. For 2006, the MCH program funded 36 positions: 14 in Chuuk, 7 in Pohnpei, 7 in Yap, 6 in Kosrae, and 2 in the FSM national government.	The MCH program in the RMI is combined with the Children with Special Health Care Needs Program. These programs provided and coordinated the full spectrum of preventive and primary health care services for mother, infants, children, and adolescents, both in hospital settings and health centers. In 2004, the program reported providing services to 33,208 eligible mothers and children and fully immunizing almost 50 percent of the 19- to 35- month-old children. The RMI reported that this percentage was below its immunization goal of 90 percent due to several challenges, including the distance between islands, limited storage facilities for vaccines, and the lack of information and outreach about the program. The MCH/Children with Special Health Care Needs Programs funded 31 positions, including 22 nurses, 7 physical assistants, 1 medical director, and 1 OB-GYN specialist.
Program observations	<p>FSM and RMI program officials told us they were unable to complete and were given exemptions for several of the MCH national performance measurements, which were required as part of the annual reports, because some of the performance measurements were beyond the level of services provided in both countries or were regarding support programs, such as Medicaid, that do not exist in these countries. Other services, such as metabolic screening or hearing impairment testing of newborns, were not available in both countries.</p> <p>The U.S. MCH State and Community Health Director stated that the national performance measurements are not “outcome measures” set by HHS for the FSM and the RMI; but that countries under the MCH program establish their own objectives and report on the results on the basis of meeting their own objectives. They are required to conduct a statewide or, in their case, countrywide needs assessments every 5 years that identifies the needs for preventive and primary care services for pregnant women, mothers, infants, and children. According to the Director, the countries tailor their targets on the basis of their own conditions, not on HHS standards.</p> <p>Hospital officials in the FSM and the RMI believed that the MCH program complemented existing health services. The Kosrae Health Director said that the state was highly dependent on MCH funding due to a lack of support from the state’s general fund since 2004. The Yap Director of Health Services said that MCH funds help support primary health care services. In Chuuk, MCH funding was used to support outreach services to the outlying villages by funding public health nurses. The RMI MCH coordinator said that although the immunization rates in the RMI appear low, there were no incidents of children dying from the diseases for which they were immunized, and he believed the MCH program was overall doing a good job.</p>	

Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

**Table 8: U.S. Department of Agriculture Rural Housing Service Housing Loan Program**

Dollars in millions		
Purpose and legislation	<p>The U.S. Department of Agriculture’s (USDA) Rural Development Housing programs has provided direct housing loans and grants for single-family dwellings, among other services. The housing programs were authorized under the Housing Act of 1949, as amended (63 Stat. 413).</p> <ul style="list-style-type: none"> <li>• Section 502 of the Housing Act of 1949, as amended, allowed loans to low-income borrowers to buy, build, rehabilitate, improve, or relocate modest eligible dwellings for use by the borrower as a permanent residence.</li> <li>• Section 504 allowed loans and grants to very low-income homeowners to make general improvements to their homes as long as the dwelling remained modest and was not used for commercial purposes.</li> </ul>	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	FY2004: \$2.12 (grant and loans) FY2005: \$2.92 (grants and loans) FY2006: \$2.13 (grants and loans)	FY2004: \$2.03 (grants and loans) FY2005: \$2.27 (grants and loans) FY2006: \$1.32 (grants and loans)
Use of funds	<p>USDA maintains a local development office in each FSM state. Two hundred ninety-nine loans and grants were approved totaling \$2,916,457 in 2005. Kosrae, the state with the smallest population, approved the greatest number of loans and grants (146), totaling \$1,497,458, or 51 percent of the total loan amount available in the FSM. The Kosrae Rural Development Manager explained that the office did not have the same type of problems, such as securing title to the property, that other states had, and that their delinquency rate was very low. Chuuk, the state with the largest population, funded the smallest number of loans (52), totaling \$299,544, or 10 percent of the total loan amount available in the FSM, in 2005. A USDA loan official stated that this disparity was due to Chuuk residents having a difficult time obtaining title to their land, which is a requirement for new home construction loans.</p> <p>In 2005, 211 loans and grants were approved in the RMI, at a value of \$2,272,020. According to the Western Pacific Area Director, while USDA has not opened an office in Ebeye, the RMI government established one there in 2001 with the intent of expanding USDA’s housing program to the island’s eligible residents. He stated that the office is staffed with RMI government employees who are trained in USDA’s housing programs and supervised by the USDA manager in Majuro. He also stated that the office initially administered the section 504 program, but there is also potential to administer the section 502 construction housing program.</p>	

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**U.S. Program Assistance to the FSM and the RMI**

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*(Continued From Previous Page)*

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Dollars in millions

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Program observations	Previously, we pointed out that the applicable Department of Housing and Urban Development income limits may not target the neediest residents based on the basis of income levels and family size of FSM and RMI applicants (see <a href="#">GAO-02-70</a> ). The income of FSM or RMI applicants has to be “low” or “very low” as determined by the Housing and Urban Development’s Adjusted Income Limits for Western Pacific Islands. Moreover, according to a USDA Rural Development official, USDA is required by law to follow these criteria. The office managers that we interviewed did not see a problem in using the Western Pacific eligibility levels for FSM residents, and one manager estimated 90 percent of residents would qualify for the very low-income threshold due to the large family sizes and low-income levels of the applicants.
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At the time of our previous report, the amended compacts between the FSM and the RMI and the United States were not a certainty, and there were concerns about the ability of borrowers to repay their loans if there were a future reduction in U.S. economic assistance. The amended compact only ensures direct U.S. grants funding until 2023, and many of these long-term loans will be active beyond that date. However, USDA was not required to consider the effects that a future reduction in U.S. economic assistance could have on the ability of its borrowers to repay their loans.

Our prior report also found that USDA Rural Development Housing Program accountability was insufficient and ineffective, and that the Hawaii State Office failed to exercise adequate oversight in the FSM and the RMI. According to USDA Rural Development, accountability has improved through the following actions: (1) the State Internal Reviews for the FSM’s four states and the RMI between 2001 and 2004 were conducted in accordance with agency regulations and guidelines, and all significant weaknesses were appropriately addressed and (2) the personnel involved with prior significant irregularities with the housing program in Pohnpei were terminated.

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Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

**Table 9: U.S. Department of Agriculture Rural Utilities Services Telecommunications Loan Program**

Purpose and legislation	The Rural Electrification Act of 1936, as amended (49 Stat. 1363), authorized the U.S. Department of Agriculture (USDA) to make loans for furnishing and improving telephone service in rural areas. The loans were intended to be used to furnish, improve, expand, construct, and operate telephone facilities or systems in rural areas. The amended compacts implementing legislation authorized programs to be made available to the FSM and the RMI. USDA Rural Development Utilities Programs, which is the successor to the Rural Electrification Administration, made a 35-year term loan to the Federated State of Micronesia Telecommunications Corporation (FSMTC) and 35-year and 17-year term loans to the Marshall Islands National Telecommunications Authority (MINTA).	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	According to a USDA Rural Development official in 1987, a USDA Rural Development Utilities loan was approved to FSMTC for \$41 million. The loan's terms were 35 years at 5 percent interest with principle payments beginning in 1990. The official also stated that the FSMTC has been making monthly payments toward the completion of the loan and is scheduled to pay it off by 2022.	According to a USDA Rural Development official in 1987, the Utilities loan was approved to the MINTA for \$18.8 million. The loan's terms were 35 years at 5 percent interest beginning in 1990 and in 1993, a second RUS loan was approved in the amount of \$4.0 million. The terms of the second loan were 17 years at 5 percent interest with principle payments beginning in 1996. In addition, the official stated that the MINTA has been making monthly payments toward the completion of the loans and is scheduled to pay off the loans in 2022 and 2010, respectively.
Use of funds	Our previous review found that the USDA loan increased telephone and communications availability to homes and businesses. In 1987, the FSMTC had 1,300 subscribers, while in 1993 the number of subscribers increased to 6,000 and to more than 9,870 throughout the FSM states in 2001. The FSMTC's 2005 audit report identified a little over 10,000 customers of landline telephone service and approximately 17,380 mobile service customers.	Our previous review found that the USDA loan increased telephone and communications availability to homes and businesses. In 1987, the company had 653 subscribers. The MINTA's 2005 audit report indicated it provided landline telephone service to 5,804 customers, 911 cellular customers, and 807 Internet users. The MINTA noted that this was a decrease in cellular subscribers from 1,198 and Internet users from 878 in 2004 because their system on Ebeye was not operational from January to May 2005.

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Program observations Both the FSMTC and the MINTA provided access to telephone service to an increasing portion of their respective national populations. According to World Bank Data, FSM telephone subscribers have increased from 16 out of every 1,000 customers in 1987 to 226 per 1,000 customers in 2004. Of the 226 subscribers, mobile telephone customers were 117 per 1,000 and landline customers were 109. RMI subscribers also grew, from 11 per 1,000 people in 1990 to 86 per 1,000 customers in 2003. Of the 86 subscribers, mobile telephone customers were 10 per 1000 and landline were 76.

According to officials from the FSM and RMI telecommunication agencies, both entities have been repaying their loans on a regular monthly basis to the USDA Rural Development Utilities Programs. At the time of our previous report, the amended compacts between the FSM and the RMI and the United States were not a certainty, and there were concerns about the ability of borrowers to repay their loans if there were a future reduction in U.S. economic assistance (see [GAO-02-70](#)). While the FSM and RMI governments have assumed responsibility for the secured loans if the borrowers are unable to pay, the dependence of the governments on U.S. funds may put such repayment at risk. However, USDA was not required to consider the effect a future reduction in U.S. economic assistance could have on the ability of its borrowers to repay their loans.

Both countries' telecommunication companies were subject to feasibility studies as a loan requirement, and both studies showed that the projects were financially viable. Each company was subject to loan fund and accounting reviews during construction. The FSMTC's 2005 single audit was an unqualified "clean" on financial statements and had no reportable findings. The MINTA 2005 annual report, which also included the independent auditor's report, gave an unqualified "clean" opinion on the financial statements with no reportable findings.

Sources: GAO analysis of documents and interviews with agency officials.

**Table 10: U.S. Department of Agriculture Rural Utilities Services Electrical Loan Program**

Purpose and legislation	USDA Rural Development Utilities Programs electrical loans, authorized under the Rural Electrification Act of 1936, as amended, (49 Stat. 1363), were intended to furnish and improve electrical service in rural areas and finance the construction of electric distribution, transmission, and generation facilities. The amended compacts implementing legislation authorized loans to be made available to the FSM and the RMI. USDA Rural Development Utilities Programs is the successor to the Rural Electrification Administration.	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	Loan application is pending from one of the four utility companies in the FSM.	According to an USDA Rural Development official, the Marshall Energy Company received a loan for about \$12.0 million in 1997. The official stated that the loan term was 20 years at 6.9 percent interest.

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**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

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Use of funds	<p>The Pohnpei Utilities Corporation filed its original loan application in 1999 with USDA Rural Development for \$10.6 million. Because of problems in obtaining title to the property where the new power plant was to be built, no action was taken on the loan application. According to a Pohnpei Utilities Corporation official, the state of Pohnpei legislature acted to give the Pohnpei Utilities title to the property in 2004 and a revised loan application for \$18 million was filed with the USDA Rural Development in July 2005. USDA Rural Development requested additional information on a number of engineering, legal, and financial issues and is awaiting a response from the Pohnpei Utilities Corporation before any further action is taken.</p>	<p>The Marshall Energy Company commissioned its 12.8 megawatt generating station in December 1999. This plant, the island's second, was built to relieve the old power plant's five generators, all of which operated at peak hours with no backup. Demand for electrical power has increased in the RMI and the number of new businesses seeking power increased by 34 percent between 1997 and 1999, and the number of private users increased by 11 percent during the same period. According to agency officials the Marshall Energy Company had to make three separate price increases in 2005 to help recoup the rising cost of oil used to operate its generators. The officials also stated that after each increase, use went down and company's revenue did not match its expectations. The officials believe future government and business users will be more stable consumers of energy, once the schools and other infrastructure projects are completed on Majuro.</p>
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Program observations	<p>Our prior report detailed that both power companies were subject to engineering and financial feasibility study requirements (see <a href="#">GAO-02-70</a>). While feasibility studies showed that the FSM project was necessary and financially viable, the loan application from the Pohnpei Utilities Corporation, which was first submitted in 1999 according to a USDA Rural Development official, has not been approved as of September 2006, because of the problems previously mentioned. In addition, the Pohnpei Utilities Corporation has been slow in responding to RUS requests for additional information related to the loan.</p>
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At the time of our previous report, the amended compacts between the FSM and the RMI and the United States were not a certainty, and there were concerns about the ability of borrowers to repay their loans if there were a future reduction in U.S. economic assistance. While the FSM and RMI governments have assumed responsibility for these secured loans if the borrowers are unable to pay, the dependence of the governments on U.S. funds may put such repayment at risk. The amended compact only ensures direct U.S. grants funding until 2023, and the Pohnpei Utilities Corporation loan, if it is funded, may still be active past this date.

The USDA Rural Development official stated that the Marshall Energy Company was that delinquent on payments to USDA for about 30 days, and that they are now current with all loan repayments. The RMI 2005 single audit stated that the Marshall Energy Company was not in compliance with certain loan coverage ratio requirements, and the Rural Development official confirmed that the Marshall Energy Company has not met these requirements for the last few years.

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Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the RMI**

**Table 11: Federal Emergency Management Agency Program/U.S. Agency for International Development**

Dollars in millions

Purpose and legislation	<p>The Federal Emergency Management Agency (FEMA) assistance is intended to help states and localities respond to, plan for, recover from, and mitigate disasters. Under the original compact, disaster assistance services and programs were to be made available to the FSM and the RMI in the same manner as assistance was made available to a U.S. state. Under the amended compacts, the programs and services of FEMA are also extended to the FSM and the RMI to the same extent that programs and services were available in 2003, but only until December 16, 2008. The FSM, the RMI, and the United States agreed in the amended compacts supplemental agreements to seek to reach agreement for alternate assistance arrangements involving a significant role for the U.S. Agency for International Development (USAID). If an agreement is not reached by December 16, 2008, all emergency and disaster preparedness, response, and recovery assistance will be provided to the FSM and the RMI by USAID. After this date, USAID will be responsible for the provision of emergency and disaster relief assistance in accordance with its statutory authorities, regulations, and policies. According to a FEMA official, funding for USAID disaster assistance activities in the FSM and the RMI will be funded from FEMA's Disaster Relief Fund. For the FSM and the RMI to secure disaster assistance from the United States, either currently or under the new arrangement, the FSM or the RMI can request that the President of the United States make an emergency or major disaster declaration. If the President declares an emergency or major disaster, the Department of Homeland Security (DHS), FEMA, and USAID will jointly (1) assess the damage caused by the emergency or disaster and (2) prepare a reconstruction plan that includes an estimate of the total amount of federal resources that are needed for reconstruction.</p>	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	<p>FEMA FY2004: \$12.36  FEMA FY2005: \$10.16  DHS FY2005: \$0.05  DHS FY2006: \$0.05</p>	<p>FEMA FY2004: \$0.05  DHS FY2005: \$0.05  DHS FY2006: \$0.05</p>
Use of funds	<p>Since 2004, FEMA has provided about \$22.5 million in disaster assistance to Yap in the FSM for recovery assistance when the island was heavily damaged by Typhoon Sudal in April 2004. The FSM also received \$50,000 a year from FEMA for disaster preparedness in 2004. Starting in 2005 and continuing through 2006, this funding will be from the DHS Emergency Management Performance Grants Program.</p>	<p>In 2004, FEMA funded the RMI with \$50,000 a year for disaster preparedness. Starting in 2005 and continuing through 2006, this funding will be from the DHS Emergency Management Performance Grants Program.</p>

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**U.S. Program Assistance to the FSM and the**  
**RMI**

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*(Continued From Previous Page)*

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Dollars in millions

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Program observations	Previously, we found that the FSM and the RMI did not appear to be developing the capability for their states and localities to respond to, plan for, recover from, and mitigate disasters (see <a href="#">GAO-02-70</a> ). In our 2006 interviews with local agency officials, we learned the following:
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- The FSM National Disaster Coordinating Officer stated that some projects on the outer islands were difficult to complete because of the distance and lack of proper equipment. In Chuuk, FEMA funds from the 2002 typhoons are still being spent to repair buildings and to build seawalls.
- The Director of the RMI's Natural Disaster Management Office said the RMI has been more responsive in utilizing disaster preparedness funds in recent years, although no FEMA funds were provided when a recent fire damaged the Majuro hospital. Instead, the RMI received support from USAID's Office of Foreign Disaster Assistance and the Department of Defense through their U.S. Army Kwajalein Atoll site.

Although both the FSM and the RMI disaster officers said that they had completed the 2004 reports that they submitted to FEMA, they were not able to locate or provide copies of the reports. The FSM Office of Public Auditor recently completed a review of files related to FEMA funds provided to the FSM to assist and recover from three typhoons—damaging Chuuk, Chata'an, in July 2002; Pongsona in January 2003; and Lupit in December 2003—and found internal control weaknesses in the disbursement of FEMA funds. These weaknesses could lead to misuse of FEMA funds. In addition, more than 18 percent of the vouchers the auditors requested (22 out of 115) could not be found. These vouchers accounted for over 40 percent of the sampled funds and represented about \$444,000 of the \$1,088,000 selected for review. The auditors made four recommendations for improving internal control procedures, which the FSM agreed to correct.

Under the amended compacts, there is a disaster assistance emergency fund established with each government, whereby the United States contributes \$200,000 each year. However, the U.S. funding comes out of the amended compact funding and not from FEMA. According to the Emergency Management and Performance Grants Program Manager, the FSM and RMI will continue to have access to DHS grant program funding for disaster preparedness even after the transition of the responsibility for disaster emergency and relief assistance goes to USAID.

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Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the RMI**

**Table 12: U.S. Postal Service Program**

Dollars in millions

Purpose and legislation	Under the amended compacts with the FSM and the RMI, the services and programs of the U.S. Postal Service (USPS) are made available to the two countries as provided for in the Federal Programs and Services Agreements accompanying the amended compacts. In these supplemental agreements, USPS agreed to maintain a reasonable and cost-effective level of service for sending mail to and from the United States and mail offices of the FSM and the RMI. In addition, under these agreements, USPS no longer provides payment for services upon delivery (commonly called Cash on Delivery). According to a USPS official pursuant to the agreements, USPS also negotiated later with the countries to end Special Services, such as Guaranteed Express Mail and Insured Mail. This official stated that U.S. postal Money Order Service was also terminated on August 31, 2006. Finally, under the amended compacts supplemental agreements, the FSM and the RMI agreed that USPS could establish special cost-related international rates or standard international rates and classifications for mail to the FSM and the RMI that would be phased in over a 5-year period, beginning no sooner than 2006. According to this official, the change became effective with the U.S. postal rate increase of January 8, 2006.	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	According to USPS officials, the cost of providing transportation, administration, and technical assistance are supposed to be reimbursed by the Department of the Interior (DOI). However, USPS reported that under the original compact, they were not reimbursed their full costs. Under the supplemental agreement to the amended compact, which allows USPS transition to international rates to the FSM and the RMI over a phased-in period, USPS expects that the amount of their subsidy for this service will decline.	
	USPS was unable to separate out the costs of providing services to the FSM, RMI, and Republic of Palau, but provided the following combined totals:	
	FY2004: Total costs - \$3.13 Reimbursed by DOI: \$2.26 Unpaid balance: \$0.87	
	FY2005: Total costs - \$2.53 Reimbursed by DOI: \$2.43 Unpaid balance: \$0.10 <sup>a</sup>	
Use of funds	USPS transports mail and parcels to and from the FSM and provides equipment, material, supplies, and technical assistance to the country. During 2005, the FSM received approximately 519,000 pounds of mail and sent out approximately 151,000 pounds.	USPS transports mail and parcels to and from the RMI and gives equipment, material, supplies, and technical assistance to the country. During 2005, the RMI received approximately 385,000 pounds of mail and sent out approximately 73,000 pounds.

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**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

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*(Continued From Previous Page)*

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Dollars in millions

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Program observations      USPS provides assistance and services in accordance with the amended compact, including mail transportation and technical assistance. As permitted in the amended compacts supplemental agreements between both countries and the United States, beginning in January 2006, USPS began to phase in new international rates. According to USPS officials, while this has resulted in increased costs to the countries for mail sent to the FSM and the RMI, they believe this will increase its revenue and thus offset some of the cost that DOI does not reimburse. The change in postal rates has created controversy in the Marshall Islands, with government and business leaders asking that a rate hike be reconsidered. There has not been a similar request from the FSM. RMI per-capita in-bound mail volume is almost 44 percent greater than the per-capita FSM in-bound mail volume.

USPS officials reported that prior to the termination of Special Services, such as Express Mail Guarantee, Cash on Delivery, and insurance, USPS had paid out thousands of dollars yearly in claims to customers.

Before postal Money Order Service was terminated in August 2006, USPS reported that it had tightened control on all money order transactions from the FSM and the RMI. A finance manager in USPS's Honolulu office reviewed the countries' transaction reports and reported any irregularities to the U.S. Postal Inspection Service. In the past 2 years, USPS reported one incident of money order irregularities that occurred in January 2006 in the RMI. In this instance, USPS fully collected all money due to the agency, and the employees involved were terminated.

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Sources: GAO analysis of documents and interviews with agency officials.

<sup>a</sup>The unpaid balances do not carry over from year to year but reflect those annual costs for which USPS was not reimbursed by DOI.

**Appendix II**  
**U.S. Program Assistance to the FSM and the RMI**

**Table 13: Federal Aviation Administration Program**

Dollars in millions

Purpose and legislation	The Vision 100 – Century of Aviation Reauthorization Act (Pub. L. No.108-176) made sponsors of airports in the FSM and the RMI eligible for grants from the Airport Improvement Program discretionary fund and the Small Airport Fund for 2004 through 2007. The access to these funds is new. Under the original compact, the Federal Aviation Administration (FAA) did not provide direct funds to the RMI and the FSM but was required to provide aviation safety services in the countries. Under the amended compacts' supplemental agreements, the United States again agreed to provide aviation safety services to (1) foster safe and efficient air travel to the two countries and (2) facilitate the establishment of aviation safety authorities and aviation safety statutory and regulatory regimes in the FSM, and provide advice and guidance to aviation safety statutory and regulatory regimes and aviation safety authorities of the RMI.	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	FY2004: \$9.45 FY2005: \$3.35 FY2006: \$11.05	FY2004: \$1.50 FY2005: \$11.00 FY2006: \$13.50
Use of funds	<p>According to a RMI Port Authority official, the RMI project is well under way, but construction has been slow because of the need to keep their single runway operational. Repair work thus has been shifted to evening hours when there are no scheduled flights.</p> <p>The rehabilitation of the runway at the Majuro airport started in September 2005 and was scheduled to be completed by September 2006.</p> <p>The FAA also provided various workshops, such as Airport Emergency Operations Training, to the personnel of the Majuro airport.</p> <p>The FSM submitted applications to use airport improvement funds in Chuuk, Kosrae, Pohnpei, and Yap. Construction within the four states was delayed due to the length of time required to develop and approve the FSM application, which included all four projects, and to the difficulty for the FAA of coordinating four separate state airport projects with staggered construction dates.</p> <p>The first work will be done in Yap, with Pohnpei, Chuuk, and Kosrae to follow. Work on the Yap airport, which suffered typhoon damages, started in January 2006 and is expected to be completed by January 2007. A short-term repair to the Pohnpei runway was completed in August 2006, and the permanent repair is scheduled to start in 2007. Bids for Aircraft Rescue and Fire Fighting building plans for each of the states were expected in November 2006.</p> <p>The FAA also provided workshops, such as Airport Emergency Operations Training, to the personnel of each airport.</p>	
Program observations	<p>The FAA appears to be working effectively with the RMI and FSM governments in implementing the Airport Improvement Program. Although officials in each country noted various delays and problems with the implementation of the projects, they have acknowledged that they would not have been able to fund these needed repairs on their own.</p> <p>The FAA is also addressing safety and security issues. For example, the FAA deployed a special inspection team in October 2005 to investigate safety and security concerns raised in a cable from the FSM U.S. Embassy. The inspection report addressed the issues raised in the cable and concluded that the equipment, facility, and personnel in place at the time of the inspection provided for safe airport operations and that the completion of the Airport Improvement Program projects at the Yap airport will bring them into full compliance with current FAA standards.</p>	

Sources: GAO analysis of documents and interviews with agency officials.

**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

**Table 14: National Weather Service Program**

Dollars in millions

Purpose and legislation	The National Weather Service (NWS) provides weather forecasts and warnings for the United States and its territories, adjacent waters, and ocean areas for the protection of life and property and the enhancement of the national economy. The FSM and the RMI weather offices provide warnings, observations, and adaptive local forecasts as well as provide inputs to Guam's weather service for its daily Western Pacific area forecasts. Under the amended compacts with the FSM and the RMI, the services and programs of the NWS are made available to the two countries as provided for in the Federal Programs and Services Agreements accompanying the amended compacts.	
	<b>U.S./FSM</b>	<b>U.S./RMI</b>
Funding	FY2004: \$0.92 FY2005: \$1.05 FY2006: \$1.02 <sup>a</sup>	FY2004: \$0.34 FY2005: \$0.46 FY2006: \$0.37 <sup>a</sup>
Use of funds	<p>The FSM weather service offices are located in Chuuk, Pohnpei, and Yap, and a weather reporting station is located in Kosrae. These facilities provide weather forecasts, limited observations, and data to FSM citizens. According to a NWS official, these offices are fully staffed by FSM citizens. The official said that the offices receive funding on a cost-reimbursable basis, and technical assistance, advice, and training through the U.S. NWS. The official also stated that according to NWS evaluations, the three weather service offices' staff are as capable and as well trained as comparable U.S.-based weather service offices.</p> <p>According to a NWS official, the NWS is funding a new Weather Forecast Office in Pohnpei estimated at \$2.8 million. The project is expected to begin in 2007.</p>	<p>The RMI weather service office provides weather forecasts and data to RMI citizens. According to a NWS official, the office is fully staffed by RMI citizens. He said that the office receives funding on a cost-reimbursable basis, and technical assistance, advice, and training through the U.S. NWS. The official also stated that according to NWS evaluations, the weather service office's staff is as capable and as well trained as comparable U.S.-based weather service offices.</p> <p>According to a NWS official, the NWS paid an additional \$1.98 million for a new Weather Forecast Office in Majuro. The majority of these funds were obligated in 2006.</p>

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**Appendix II**  
**U.S. Program Assistance to the FSM and the**  
**RMI**

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*(Continued From Previous Page)*

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Dollars in millions

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Program observations	<p>The program provides the FSM with the facilities, equipment, technical assistance, and resources needed to operate weather services.</p> <p>The NWS Pacific Region Director stated that an example of the program's effectiveness was demonstrated in Yap in relation to Typhoon Sudal, which struck on April 8-9, 2004. As a result of weather service outreach and education in Yap, the local communities responded to early warnings of Typhoon Sudal, one of the strongest storms ever to strike Yap, and were well prepared when it struck. Yap residents suffered no deaths or serious injuries from the storm.</p>	<p>The program provides the RMI with the facilities, equipment, technical assistance, and resources needed to operate weather services.</p> <p>The NWS Pacific Region Director stated that outreach and training performed on a continuing basis by both local office personnel and NWS personnel from Guam provide the basis for community readiness and response.</p>
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Sources: GAO analysis of documents and interviews with agency officials.

<sup>a</sup>As of August 2006.

# U.S. Funds to Be Provided to the RMI Related to Kwajalein Atoll, 2004 through 2023

**Table 15: U.S. Funds to Be Provided to the RMI Related to Kwajalein Atoll under the Terms of the Amended Compact, 2004 through 2023**

Dollars in millions			
Compact reference	2004-2013	2014 <sup>a</sup> -2023	Purpose
Section 211(b)(1) <sup>b</sup>	\$3.1	\$5.1	To address the special needs of the community at Ebeye and other Marshallese communities within Kwajalein Atoll. <sup>c</sup>
Section 211(b)(2) <sup>b</sup>	1.9	1.9	To address the special needs of the community at Ebeye and other Marshallese communities within Kwajalein Atoll, <i>with emphasis on the Kwajalein landowners.</i> <sup>d</sup>
Section 211(b)(3) <sup>b</sup>	0.2	0.2	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. <sup>e</sup>
Section 212 – Kwajalein Impact and Use	15.0	18.0	Funds are provided to the RMI government to compensate for any impacts of the U.S. military on the atoll. The RMI government uses the funds to compensate Kwajalein Atoll landowners for U.S. access to the atoll.

Source: Amended RMI compact, Pub. L. No. 108-188.

Note: The funds shown in this table are subject to inflation adjustment, as provided under section 218 of the compact. Furthermore, the "Agreement Regarding the Military Use and Operating Rights of the Government of the United States in the Republic of the Marshall Islands Concluded Pursuant to sections 321 and 323 of the Compact of Free Association, as Amended" states that the funds referenced in the table shall be provided through fiscal year 2023, "and thereafter for as long as this agreement remains in effect."

<sup>a</sup>Beginning in 2014, the amount of total funding provided to the RMI will increase by \$5 million. Of this amount, \$3 million is to be allocated to "Kwajalein Impact and Use" (sec. 212), while an additional \$2 million is to be added to annual grants to address the special needs of Kwajalein Atoll (sec. 211(b)(1)).

<sup>b</sup>Funds for this use are made available under section 211(a) that provides grant assistance for education, health care, the environment, public sector capacity building, and private sector development.

<sup>c</sup>Within its allocation of funds for the education, health, and infrastructure sector grants, the RMI designated funds for Kwajalein Atoll in 2004 and 2005.

<sup>d</sup>These funds represent a continuation of funds that had gone to the Kwajalein Atoll Development Authority under the original compact.

<sup>e</sup>Within its allocation of funds for the environment sector grant, the RMI designated funds for Kwajalein Atoll in 2004 and 2005.

# FSM and RMI Sector Grants, 2004 through 2006

Table 16 lists the compact sector grant allocation to the five FSM governments in 2004 through 2006. Table 17 lists the compact sector grant allocation of the RMI, including the Kwajalein funding, in 2004 through 2006.

**Table 16: Sector Grant Allocations to the Five FSM Governments, 2004 through 2006**

Section grant/recipient	2004		2005		2006	
	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant
<b>Education</b>						
FSM national government	\$4,324,122	17%	\$4,511,317	17%	\$4,159,081	16%
Chuuk	8,140,265	31	8,804,369	32	9,432,618	36
Kosrae	1,883,853	7	2,070,432	8	2,412,498	9
Ponhpei	7,373,651	28	7,469,772	28	6,978,447	27
Yap	4,243,681	16	4,249,157	16	3,149,415	12
<b>Subtotal</b>	<b>\$25,965,572</b>	<b>100%</b>	<b>\$27,105,047</b>	<b>100%</b>	<b>\$26,132,059</b>	<b>100%</b>
<b>Environment</b>						
FSM national government	\$79,477	4%	\$111,421	5%	\$0	--
Chuuk	378,394	19	502,499	21	798,428	37%
Kosrae	302,523	15	296,592	12	335,240	16
Ponhpei	666,944	33	688,181	29	665,807	31
Yap	595,854	29	791,258	33	337,977	16
<b>Subtotal</b>	<b>\$2,023,192</b>	<b>100%</b>	<b>\$2,389,951</b>	<b>100%</b>	<b>\$2,137,452</b>	<b>100%</b>
<b>Health</b>						
FSM national government	\$553,613	4%	\$763,235	4%	\$764,383	5%
Chuuk	4,691,707	30	5,595,636	32	6,292,745	38
Kosrae	1,326,663	9	1,674,212	10	1,763,553	11
Ponhpei	5,989,461	39	6,200,560	36	4,898,393	30
Yap	2,881,672	19	3,197,090	18	2,675,865	16
<b>Subtotal</b>	<b>\$15,443,116</b>	<b>100%</b>	<b>\$17,430,733</b>	<b>100%</b>	<b>\$16,394,939</b>	<b>100%</b>
<b>Infrastructure</b>						
<b>Subtotal</b>	<b>\$17,119,155</b>	<b>100%</b>	<b>\$17,249,121</b>	<b>100%</b>	<b>\$24,335,717</b>	<b>100%</b>
<b>Private sector</b>						
FSM national government	\$513,091	14%	\$0	--	\$0	--
Chuuk	1,338,874	35	1,403,876	35%	1,498,616	37%
Kosrae	795,261	21	988,025	24	606,029	15

**Appendix IV  
FSM and RMI Sector Grants, 2004 through  
2006**

(Continued From Previous Page)

Section grant/recipient	2004		2005		2006	
	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant
Ponhpei	525,423	14	657,602	16	887,817	22
Yap	613,470	16	989,407	24	1,046,701	26
<b>Subtotal</b>	<b>\$3,786,119</b>	<b>100%</b>	<b>\$4,038,910</b>	<b>100%</b>	<b>\$4,039,163</b>	<b>100%</b>
<b>Public sector capacity building</b>						
FSM national government	\$4,287,697	37%	\$608,028	8%	\$0	--
Chuuk	2,853,813	24	3,001,410	39	2,724,099	44%
Kosrae	1,013,866	9	1,113,866	14	1,346,976	22
Ponhpei	1,676,163	14	1,542,488	20	759,254	12
Yap	1,831,307	16	1,520,446	20	1,345,585	22
<b>Subtotal</b>	<b>\$11,662,846</b>	<b>100%</b>	<b>\$7,786,238</b>	<b>100%</b>	<b>\$6,175,914</b>	<b>100%</b>
<b>Total</b>	<b>\$76,000,000</b>	<b>--</b>	<b>\$76,000,000</b>	<b>--</b>	<b>\$79,215,244</b>	<b>--</b>

Source: GAO analysis of FSM 2004 through 2006 sector grant agreements.

**Table 17: RMI Sector Grants, Including Kwajalein Funding, 2004 through 2006**

Sector grant	2004		2005		2006	
	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant
Education	\$9,648,932	90%	\$9,541,921	86%	\$10,834,083	91%
Kwajalein funding	1,100,000	10	1,600,000	14	1,100,000	9
<b>Subtotal</b>	<b>\$10,748,932</b>	<b>100%</b>	<b>\$11,141,921</b>	<b>100%</b>	<b>\$11,934,083</b>	<b>100%</b>
Environment	\$200,000	50%	\$202,360	50%	\$202,480	50%
Kwajalein funding	200,000	50	202,360	50	205,520	50
<b>Subtotal</b>	<b>\$400,000</b>	<b>100%</b>	<b>\$404,720</b>	<b>100%</b>	<b>\$408,000</b>	<b>100%</b>
Health	\$5,894,448	85%	\$5,564,197	79%	\$5,597,181	84%
Kwajalein funding	1,000,000	15	1,500,000	21	1,085,560	16
<b>Subtotal</b>	<b>\$6,894,448</b>	<b>100%</b>	<b>\$7,064,197</b>	<b>100%</b>	<b>\$6,682,741</b>	<b>100%</b>
Infrastructure	\$13,700,000	93%	\$13,485,745	100%	\$12,495,679	93%
Kwajalein funding	1,000,000	7	0	--	1,000,000	7
<b>Subtotal</b>	<b>\$14,700,000</b>	<b>100%</b>	<b>\$13,485,745</b>	<b>100%</b>	<b>\$13,495,679</b>	<b>100%</b>
Private sector	\$356,620	100%	\$361,943	100%	\$361,943	10%
<b>Subtotal</b>	<b>\$356,620</b>	<b>100%</b>	<b>\$361,943</b>	<b>100%</b>	<b>\$361,943</b>	<b>100%</b>

**Appendix IV  
FSM and RMI Sector Grants, 2004 through  
2006**

*(Continued From Previous Page)*

Sector grant	2004		2005		2006	
	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant	Sector grant amount	Percentage of total sector grant
Public sector capacity building	\$0	--	\$103,512	100%	\$103,154	100%
<b>Subtotal</b>	<b>\$0</b>	<b>--</b>	<b>\$103,514</b>	<b>100%</b>	<b>\$103,514</b>	<b>100%</b>
Special Needs (Ebeye)	\$1,900,000	100%	\$1,992,420	100%	\$1,882,440	100%
<b>Subtotal</b>	<b>\$1,900,000</b>	<b>100%</b>	<b>\$1,992,420</b>	<b>100%</b>	<b>\$1,882,440</b>	<b>100%</b>
<b>Total</b>	<b>\$33,100,000</b>	<b>--</b>	<b>\$32,562,040</b>	<b>--</b>	<b>\$32,985,960</b>	<b>--</b>

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

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# Single Audit Reports for the FSM and the RMI, 2001 through 2005

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The FSM national government and the individual states in most cases did not submit their required single audit reports on time for 2001 through 2005, while the RMI has generally improved the timeliness of its single audits, with its last three reports submitted by the established deadlines. In nearly all cases, auditors rendered qualified audit opinions on both the financial reporting and compliance with requirements of major federal programs for those single audit reports that were submitted. Furthermore, internal control weaknesses have persisted in both countries since we last reported on single audits in October 2003.<sup>1</sup> In March 2006, JEMCO threatened to take action, such as withholding funds, designating the FSM as a high-risk grantee, or conditionally approving sector grants for 2007, if the FSM and its states did not submit their 2005 single audits by July 1, 2006.<sup>2</sup>

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## Single Audits Were Not Timely, but Timeliness Improved

The FSM and the RMI are required to submit audit reports each year to comply with compact and fiscal procedures agreement requirements. The submitted audits are to be conducted within the meaning of the Single Audit Act,<sup>3</sup> as amended. Single audits are a key control for the oversight and monitoring of the FSM and RMI governments' use of U.S. awards, and are due to the Federal Audit Clearinghouse<sup>4</sup> 9 months after the end of the

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<sup>1</sup>See GAO, *Compact of Free Association: Single Audits Demonstrate Accountability Problems over Compact Funds*, [GAO-04-7](#) (Washington, D.C.: Oct. 7, 2003). Our review of 30 single audit reports from the FSM national government, four FSM states, and the RMI for 1996 through 2000 identified pervasive and persistent compliance and financial-related audit findings. These reports contained 458 audit findings over this period and showed recurring audit findings, despite the corrective action plans that were meant to address these problems.

<sup>2</sup>The FSM national government's single audit cannot be completed until the states' single audits have been completed. If any one state is late, the FSM national government's audit becomes automatically late. Chuuk submitted both its 2004 and 2005 single audits in July 2006, which were 13 and 1 months late, respectively.

<sup>3</sup>All nonfederal entities that expend \$500,000 or more of federal awards in a year are required to obtain an annual audit in accordance with the Single Audit Act, as amended. 31 U.S.C. Chp. 75.

<sup>4</sup>The Federal Audit Clearinghouse is an automated database of single audit information.

audited period.<sup>5</sup> All single audit reports include the auditor’s opinion on the audited financial statements and a report on the internal controls related to financial reporting. The single audit reports also include the auditor’s opinion on compliance with requirements of major federal programs and a report on internal controls related to compliance with laws, regulations, and the provisions of contracts or grant agreements. The FSM national government and the individual states in most cases did not submit their single audit reports<sup>6</sup> on time for 2001 through 2005, while the RMI has generally improved the timeliness of its single audits, with its last three reports submitted by the established deadlines. Table 18 shows the timeliness of reports for the FSM and the RMI.

**Table 18: Single Audit Act Report Submissions, 2001 through 2005**

Fiscal year-end	Number of months single audits were received past deadline, by country					
	RMI	FSM national government	Chuuk	Kosrae	Pohnpei	Yap
2001	15	27	12	26	26	19
2002	3	26	38	11	11	12
2003	0	25	24	21	19	18
2004	0	14	13	12	7	9
2005	0	2	1	0	0	0

Sources: GAO analysis of OMB Circular A-133, auditors’ reports, and Federal Audit Clearinghouse submission dates.

Note: The deadline is 9 months after the close of entity’s fiscal year. The date received is based on the most recent date that the required Single Audit form is received by the Federal Audit Clearinghouse.

<sup>5</sup>The fiscal procedures agreements specify that the audits are due 6 months after the fiscal year-ends, but Interior believes that was a mistake in the agreements, and, according to Interior officials, they have allowed the countries 9 months, which is generally the required time frame under the Single Audit Act. According to the act, there is generally no standard due date for the annual single audit. The audited entity, upon hiring the auditor, negotiates a due date for the audit within 9 months after the close of the entity’s fiscal year. The entity must have time to read the report and prepare the corrective action plan that is required to be included in the reporting package.

<sup>6</sup>Single audits generally cover the entire organization and focus on recipients’ internal controls over financial reporting and compliance with laws and regulations governing federal awards. Among other information, single audit reports include the auditor’s opinion on the audited financial statements; reports on internal controls related to the financial reporting and major programs; and reports on compliance with laws, regulations, and the provisions of contracts or grant agreements.

The lack of timeliness of the single audit reports for 2001 through 2005, especially for the FSM and its four states, has meant that U.S. agencies have limited knowledge of the territorial governments' accountability over U.S. funds received. In addition, the governments' inability to prepare financial statements and have them audited within 9 months of the fiscal year-end suggests weaknesses in the underlying financial systems and processes needed to produce financial information to efficiently and effectively manage the day-to-day operations of government.

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## Nearly All Audit Opinions on Financial Reporting Were Qualified and Contained Material Weaknesses and Reportable Conditions

Among the 30 audit reports on financial reporting submitted by the FSM national and its state governments and the RMI for 2001 through 2005, 26 reports received qualified opinions.<sup>7</sup> In 2005, Pohnpei received an unqualified<sup>8</sup> ("clean") audit opinion on their financial statements. In 2004 and 2005, Chuuk received a disclaimed<sup>9</sup> opinion on its financial statement, and Yap received a qualified/adverse<sup>10</sup> opinion on its 2004 financial statement. Table 19 shows the type of financial statement audit opinions for the FSM and the RMI from 2001 through 2005.

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<sup>7</sup>A qualified opinion is given when the auditor finds conditions such as a lack of supporting evidence or a restriction on the scope of the audit.

<sup>8</sup>An unqualified opinion is given when the auditor is reasonably assured that the financial statements are free of material misstatements.

<sup>9</sup>A disclaimer is given when the auditor cannot express an opinion on the financial statements.

<sup>10</sup>An adverse opinion is given when the auditor concludes that the financial statements are not fairly presented. In the Yap 2004 single audit report, the auditors gave an adverse opinion on the component units because they could not determine the propriety of fixed assets of the Yap Fishing Authority and Diving Seagull, Inc., and the lack of audited financial statements of Yap Fresh Tuna, Inc. Overall, this is considered a qualified/adverse opinion because the other Yap entities were given an unqualified and qualified opinion.

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**Table 19: Financial Statement Audit Opinions for the RMI and the FSM, 2001 through 2005**

Year	Type of opinion					
	RMI	FSM national government	Chuuk	Kosrae	Pohnpei	Yap
2001	Qualified	Qualified	Qualified	Qualified	Qualified	Qualified
2002	Qualified	Qualified	Qualified	Qualified	Qualified	Qualified
2003	Qualified	Qualified	Qualified	Qualified	Qualified	Qualified
2004	Qualified	Qualified	Disclaimed	Qualified	Qualified	Qualified/ Adverse
2005	Qualified	Qualified	Disclaimed	Qualified	Unqualified "clean"	Qualified

Sources: Forms SF-FACs and single audit reports in the Federal Audit Clearinghouse database.

All of the audit opinions of the FSM national government’s financial statements from 2001 through 2005 were qualified. The opinions were qualified because of the lack of supporting evidence and restrictions on the scope of the audit. For example, the auditors qualified their opinion on the financial statements in the 2005 FSM report due to the following matters:

- Their inability to determine (1) the propriety of cash and cash equivalents, receivables, advances, and amounts due to the FSM state governments for the governmental activities and the general fund; (2) receivables and amounts due to the FSM state governments for the U.S. Federal Grants Fund and the aggregate remaining fund information; and (3) cash and cash equivalents and receivables for the Asian Development Bank Loan Fund, and their effect on the determination of revenues and expenditures/expenses for government activities and the remaining aggregate remaining fund information.
- The lack of audited financial statements of the National Fisheries Corporation; Micronesia Longline Fishing Company; Yap Fishing Corporation; Yap Fresh Tuna Inc.; Chuuk Fresh Tuna, Inc.; and Kosrae Sea Venture, Inc.

In addition, all of the audit opinions of the RMIs’ financial statements during the 2001 through 2005 period were qualified. For example, as of 2005, the auditors still could not determine the following:

- the propriety of governmental activities’ capital assets,
- net assets invested in capital assets, and

- the net of related debt and depreciation expenses.

The auditors also were unable to obtain audited financial statements for the following RMI component units:<sup>11</sup>

- Ministry of Education Head Start Program;
- Air Marshall Islands, Inc.;
- Kwajalein Atoll Joint Utilities Resources, Inc.; and
- Marshall Islands Development Bank.

The single audits also identified material weaknesses and reportable conditions related to the 2005 financial statements reports, totaling 57 for the FSM and 2 for the RMI (see table 20). These findings indicated a lack of sound internal control over financial reporting, which is needed to (1) adequately safeguard assets; (2) ensure that transactions are properly recorded; and (3) prevent or detect fraud, waste, and abuse. For example, in the 2005 FSM single audit report, material weaknesses included (1) the lack of documentation to support the amounts and disposition of fixed assets, (2) the lack of reconciliation of U.S. program receivables, (3) the lack of monitoring of receivable billing and collecting, and (4) unreimbursed U.S. expenditures. In the RMI 2005 single audit, the auditors found material weaknesses that included the use of unaudited financial statements from several component units and the lack of fixed asset inventory.

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<sup>11</sup>A component unit is a legally separate organization that a primary government is financially accountable for and must include as part of its financial reporting entity for fair presentation in conformity with generally accepted accounting practices. These component units also can be other organizations that due to their relationship to the primary government, if excluded would cause the reporting entity's financial statements to be misleading or incomplete.

**Appendix V**  
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**Table 20: Numbers of FSM and RMI Material Weaknesses and Reportable Conditions in Internal Control over Financial Statement Reporting Identified in Single Audit Reports, 2005**

<b>Internal control over financial reporting</b>	<b>RMI</b>	<b>FSM total</b>	<b>FSM national government</b>	<b>Chuuk</b>	<b>Kosrae</b>	<b>Pohnpei</b>	<b>Yap</b>
Material weaknesses	2	20	7	11	2	0	0
Reportable conditions	0	37	15	2	10	5	5
<b>Total</b>	<b>2</b>	<b>57</b>	<b>22</b>	<b>13</b>	<b>12</b>	<b>5</b>	<b>5</b>

Sources: Single audit reports for 2005 from the FSM national government and four states and the RMI.

Note: Material weaknesses are a subset of reportable conditions, but such weaknesses are considered more serious. To compute the number of reportable conditions that were not material weaknesses shown in this table, we subtracted the number of material weaknesses from the total findings.

We found that 14 of the 57 findings previously mentioned from the 2005 FSM single audit report on financial reporting were recurring problems from the previous year or had been reported for several consecutive years. Likewise, the 2 findings from the 2005 RMI single audit report were recurring problems reported for several consecutive years. The FSM has developed corrective action plans to address about 91 percent of the financial statement findings in the 2005 single audits, and the RMI has developed plans for both of its financial statement reportable findings. For example, the FSM said that it would make efforts to reconcile intergovernmental balances and discuss this issue with all four states in 2006, and the RMI said that it would hire a consultant qualified to conduct the valuation of fixed assets.

## All Audit Opinions on Compliance with Requirements of Major Federal Programs Were Qualified and Contained Material Weaknesses and Reportable Conditions

In addition to the auditor’s report on financial statement findings, the auditors also provide a report on the countries’ compliance with requirements of major federal programs. All 30 of the audit reports on such compliance submitted by the FSM national and its state governments and the RMI for 2001 through 2005 received qualified opinions. Moreover, in the 2005 single audit reports of compliance with requirements of major federal programs, auditors reported 45 material weaknesses and reportable conditions findings for the FSM and 11 for the RMI (see table 21). For example:

- In the FSM, findings that were material weaknesses included (1) the lack of internal controls over cash management requirements and (2) no reconciliation of U.S. grants receivable per Catalog of Federal Domestic Assistance number or by program number.
- In the RMI, findings that were material weaknesses included (1) a lack of inventory of fixed assets and (2) the lack of audit reports from subrecipient component units.

**Table 21: Numbers of FSM and RMI Material Weaknesses and Reportable Conditions in Internal Control over Compliance with Requirements of Major Federal Programs Identified in Single Audit Reports, 2005**

Internal control over compliance with federal awards	FSM national government						
	RMI	FSM total	Chuuk	Kosrae	Pohnpei	Yap	
Material weaknesses	6	22	2	9	11	0	0
Reportable conditions	5	23	18	0	0	2	3
<b>Total</b>	<b>11</b>	<b>45</b>	<b>20</b>	<b>9</b>	<b>11</b>	<b>2</b>	<b>3</b>

Sources: Single audit reports for 2005 from the FSM national government and four states and the RMI.

Note: Material weaknesses are a subset of reportable conditions, but such weaknesses are considered more serious. To compute the number of reportable conditions that were not material weaknesses shown in this table, we subtracted the number of material weaknesses from the total findings.

We found that only 4 of the 45 findings from the 2005 FSM single audit report, and only 2 of the 11 findings from the 2005 RMI single audit report, were recurring problems from the previous year or had recurred for several consecutive years. For the RMI, this was a significant shift from 2002, when 8 of the 11 findings were recurring problems from the previous year or had recurred for several consecutive years. The FSM has developed corrective

action plans to address about 60 percent of the 2005 single audit's reportable findings on compliance with requirements of major federal programs, and the RMI has developed plans for all its reportable findings on such compliance. For example, the FSM said that on October 1, 2005, a new procedure was implemented to properly monitor the drawdown of U.S. funds and to properly reimburse the states on time, and the RMI said that it would hire a consultant to assist component units in rectifying their accounting books and records.

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## High-Risk Designations and Other Sanctions Threatened by OIA as Late Reports and Other Problems Persist

According to OMB Circular A-133, if a grantee fails to complete its single audit reports, U.S. agencies may impose sanctions such as, but not limited to, (1) withholding a percentage of federal U.S. awards until single audits are completed satisfactorily, (2) withholding or disallowing overhead costs, (3) suspending U.S. federal awards until the single audit is conducted, or (4) terminating the U.S. federal award. At the special March 2006 JEMCO meeting, the OIA Budget Director noted that single audits were the most important indicator of financial stability provided by a grantee to a grantor. He emphasized that OIA was particularly concerned about the lack of FSM single audits and notified FSM JEMCO participants that OIA intended to "apply a remedy" for single audit noncompliance beginning October 1, 2006, that would include the possibility of withholding cash payments. OIA also may take necessary steps to have the FSM designated as a "high-risk" grantee. Finally, OIA recommended to JEMCO in the March 2006 meeting that if audits were not completed by July 1, 2006, that it only conditionally approve sector grants for 2007 so that funds may only be released to entities in compliance with single audit requirements. This warning appeared to have an impact on most of the FSM states, because Kosrae, Pohnpei, and Yap completed their 2005 reports on time.

Other U.S. agencies have not designated the FSM as high risk in the past, even though they can assign a grantee as high risk if the grantee has a history of unsatisfactory performance, is not financially stable, has an inadequate management system, has not conformed to the terms and conditions of previous awards, or is otherwise irresponsible. Federal agencies that designate a grantee as high risk may impose special terms

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and conditions.<sup>12</sup> Currently, none of the U.S. agencies providing funds to the FSM and the RMI have designated either country as a high-risk grantee, although this may be a possibility if the single audits are not completed within the deadlines requested by Interior. Officials from the Department of Education told us that, because most of the direct grant funding to the FSM has been subsumed by the Special Education Grant, which is administered by Interior, Education now has an even smaller share of the U.S. funds in the FSM, and therefore Interior would be in the best position to invoke a high-risk designation if warranted for a particular grant. Nevertheless, Education officials did take into account the lack of single audit performance when administering program funds and, in the case of funds for special education, had imposed additional reporting requirements.

Tables 22 and 23 show the total numbers of material weaknesses and reportable conditions identified in single audit reports for the FSM and the RMI in 2001 through 2005.

**Table 22: Numbers of Material Weaknesses and Reportable Conditions Identified in Single Audit Reports for FSM National Government and States, 2001 through 2005**

Year	Location	Reportable findings on internal control over financial reporting			Reportable findings on internal control over compliance with federal awards		
		Material weaknesses	Reportable conditions only	Total	Material weaknesses	Reportable conditions only	Total
2001	FSM national government	5	10	15	1	1	2
	Chuuk	2	16	18	2	6	8
	Kosrae	15	1	16	1	4	5
	Pohnpei	10	2	12	2	0	2
	Yap	1	7	8	1	13	14
	<b>Total</b>	<b>33</b>	<b>36</b>	<b>69</b>	<b>7</b>	<b>24</b>	<b>31</b>
2002	FSM national government	11	1	12	2	0	2
	Chuuk	5	15	20	2	6	8
	Kosrae	6	9	15	5	0	5
	Pohnpei	8	7	15	5	1	6

<sup>12</sup>The Grants Management Common Rule was established in 1987 under presidential direction to adopt governmentwide terms and conditions for grants to state and local governments. Each federal department incorporates the Grants Management Common Rule in its agency regulations.

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Year	Location	Reportable findings on internal control over financial reporting			Reportable findings on internal control over compliance with federal awards		
		Material weaknesses	Reportable conditions only	Total	Material weaknesses	Reportable conditions only	Total
	Yap	1	6	7	1	14	15
	<b>Total</b>	<b>31</b>	<b>38</b>	<b>69</b>	<b>15</b>	<b>21</b>	<b>36</b>
2003	FSM national government	6	2	8	3	1	4
	Chuuk	2	8	10	7	0	7
	Kosrae	3	4	7	2	0	2
	Pohnpei	1	6	7	0	3	3
	Yap	1	7	8	1	5	6
	<b>Total</b>	<b>13</b>	<b>27</b>	<b>40</b>	<b>13</b>	<b>9</b>	<b>22</b>
2004	FSM national government	9	16	25	2	14	16
	Chuuk	17	2	19	12	0	12
	Kosrae	0	9	9	9	0	9
	Pohnpei	0	7	7	0	5	5
	Yap	1	6	7	0	5	5
	<b>Total</b>	<b>27</b>	<b>40</b>	<b>67</b>	<b>23</b>	<b>24</b>	<b>47</b>
2005	FSM national government	7	15	22	2	18	20
	Chuuk	11	2	13	9	0	9
	Kosrae	2	10	12	11	0	11
	Pohnpei	0	5	5	0	2	2
	Yap	0	5	5	0	3	3
	<b>Total</b>	<b>20</b>	<b>37</b>	<b>57</b>	<b>22</b>	<b>23</b>	<b>45</b>

Sources: Single audit reports for 2001 through 2005 from the FSM national government and four states.

Note: Material weaknesses are a subset of reportable conditions, but such weaknesses are considered more serious. To compute the number of reportable conditions that were not material weaknesses shown in this table, we subtracted the number of material weaknesses from the total findings.

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**Table 23: Numbers of RMI Material Weaknesses and Reportable Conditions Identified in Single Audit Reports, 2001 through 2005**

Year	Reportable findings on internal control over financial reporting			Reportable findings on internal control over compliance with federal awards		
	Material weaknesses	Reportable conditions only	Total	Material weaknesses	Reportable conditions only	Total
2001	7	3	<b>10</b>	8	0	<b>8</b>
2002	9	8	<b>17</b>	10	1	<b>11</b>
2003	7	8	<b>15</b>	9	8	<b>17</b>
2004	2	1	<b>3</b>	6	3	<b>9</b>
2005	2	0	<b>2</b>	6	5	<b>11</b>

Sources: Single audit reports for 2001 through 2005 from the RMI.

Note: Material weaknesses are a subset of reportable conditions, but such weaknesses are considered more serious. To compute the number of reportable conditions that were not material weaknesses shown in this table, we subtracted the number of material weaknesses from the total findings.

# FSM Compliance with Special Sector Grant Terms and Conditions

Sector	Fiscal year	Special terms and conditions in sector grants	Status according to OIA
Education	2004	The FSM shall have 60 days from the date of grant award to realign this sector budget so that activities and related costs are clearly defined for each funding input under the grant. In doing so, the FSM should use a common or unified format wherever possible.	Between October and December 2003, OIA lacked education staff needed to conduct the follow-up.
		The FSM shall have 60 days from the date of grant award to identify the amounts, sources, and the specific strategic focus and activities of all noncompact funding and direct technical assistance that relates to this sector.	Between October and December 2003, OIA lacked education staff needed to conduct the follow-up.
		The FSM shall submit within 180 days from the date of grant award a streamlined and refined statement of outcome measures, baseline data, and annual targets to enable the tracking of outputs and outcomes. In doing so, the FSM should use a common or unified format wherever possible. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the FSM submits for 2005 funding.	Between January and March 2004, OIA staff had discussions with all state directors of education and other sectors, expressing concern regarding performance-based budgeting and the lack of a unified format. OIA did not receive formal communication regarding these concerns from the FSM in 2004. The new education grant manager placed a similar condition on the FSM in 2005.
		As a condition precedent to the drawdown of funding for this specific activity, Pohnpei shall provide written materials to justify the request for \$52,463 for the funding of the public library from the education sector grant.	Written justification was not received from the Pohnpei Department of Education. However, OIA held discussions with the Pohnpei Director of Education during OIA's first site visit in February 2004. The OIA education grant manager approved the use of education funds to support the library's purchase of children's books.
2005	The FSM shall submit within 90 days from the date of the grant award a streamlined and refined statement of national strategic goals, outcome measures, baseline data, and annual targets to enable the tracking of uniform and consistent, national, and state outputs and outcomes. In doing so, the FSM should use a common or unified format.	The FSM did not meet the deadline. OIA reminded the FSM National Division of Education (NDOE) of the requirement several times, and finally indicated it would cut off funds to them in March 2005 if the submission was not received. The FSM provided the required submission in late February, but the quality of the information was deemed "questionable" by OIA.	
		The FSM shall conduct four evaluation studies and performance assessments.	

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<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		<p>(1) Within 60 days from the date of the grant award, an analysis of school year 2004-2005 staffing patterns will be submitted and include, but not be limited to, the number of students enrolled as of October 1, 2004; the number of staff by category (principals, vice-principals, teachers, teacher assistants, specialists, support staff, etc.) as of October 1, who are full-time and part-time employees; changes in staffing from school year 2003-2004; the number of staff in each category in each school; and the October 1 student-to-teacher ratio.</p> <p>(2) Within 60 days from the date of the grant award, an inventory of textbooks and related resource materials for each grade in the core subjects of language arts, math, social studies, and science will be conducted and submitted.</p> <p>(3) Within 180 days from the date of the grant award, a national inventory of educational facilities will be conducted and progress to date submitted. The inventory will include, but not be limited to, the number of educational buildings, age of each, condition of each, list of repair needs by school, and date when last renovated.</p> <p>(4) Within 180 days from the date of the grant award, an evaluation of the effectiveness of the national student testing (NST) systems will be conducted and progress to date submitted. The NST and state testing instruments will be evaluated for validity and alignment to state standards and curricula.</p>	<p>(1) The staffing patterns report was submitted in a summarized form. The summary document did not include data on all of the staffing categories cited in the grant condition—for example, no data on vice- principals were received.</p> <p>(2) Each state completed their textbook inventory and submitted it to NDOE. NDOE transmitted the document “as is,” without a summary or any analysis. Yap’s report file could not be opened; a revision was received a few days later.</p> <p>(3) OIA was asked by NDOE to provide a sample format for the states to follow. NDOE was late in sending out the proposed format to the states. Thus, the four state submissions came in different formats, with no summary or analysis provided.</p> <p>(4) The report was completed for the FSM by a consultant. OIA learned later that the FSM hired the same consultant who had created the NST to evaluate it.</p>
		<p>The FSM shall provide data of educational progress no less than annually, in time for submittal to JEMCO. At a minimum, data on the 20 indicators of educational progress discussed at the August 11 JEMCO meetings will be gathered and submitted by state, along with a national summary, no later than July 30, 2005.</p>	<p>The FSM submitted a summary document, but it contained little narrative. According to OIA, it was difficult to decipher the meaning of some of the charts. The Office of Compact Management questioned the quality of the report, but it was submitted unchanged to OIA. A later submission contained a narrative analysis.</p>
	2006	<p>The FSM shall ensure that within 90 days of the grant award, the FSM Department of Health, Education, and Social Affairs, in consultation with the four state departments of education and OIA, shall develop a national process and procedure for the procurement of textbooks on a 5-year purchasing cycle.</p>	<p>The FSM submitted the final national process and procedure document to OIA on March 16, 2006. According to OIA, the document was well thought out and included significant state input, but did not include the proposed purchasing cycle for each state. This omission will be a grant condition in 2007.</p>

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<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		The FSM shall ensure that in 2006 through 2008, no less than \$2.5 million of compact education sector funding allocated to state governments shall be used to purchase textbooks for the primary and secondary education systems and related instructional materials.	The states provided revised line item budgets, indicating their contribution to the \$2.5 million requirement in November 2005. OIA withheld a portion of the education sector grant funding in October and November 2005 until this requirement was met.
		The FSM shall provide data of educational progress no less than annually, in time for submittal to JEMCO. At a minimum, data on the 20 indicators of educational progress discussed at the August 11 JEMCO meetings will be gathered and submitted by state, along with a national summary, no later than July 30, 2006.	The FSM missed the original July 30, 2006, deadline. However, OIA granted their requested extension until August 14, 2006. The report on the 20 indicators was received on that date.
		<b>SEG:</b> The FSM shall submit, for approval by OIA, a written description and annual plan for the use of the grant funds. No funds may be disbursed until the plan is approved.	OIA approved the plan submitted by the FSM in September 2005.
		<b>SEG:</b> Timelines for all major objectives and activities must match the annual funding period. Timelines for the 2005 funding period are due to OIA by October 31, 2005.	Revised timelines were received directly from each state, with no attempt to submit them as an FSM-wide deliverable.
		<b>SEG:</b> The FSM shall submit to OIA by December 31, 2005, a framework for each sub-grantee that illustrates how the programs and goals funded by the Special Education Grant correlate to the programs and goals funded by the compact education sector grant, and how all correlate to the FSM Strategic Development Plan's education goals.	The national submission was received on January 30, 2006. According to OIA, it was obvious the national submission was written by one author who used little of what the states submitted.
<b>Environment</b>	2004	The FSM shall have 60 days from the date of grant award to realign this sector budget so that activities and related costs are clearly defined for each funding input under the grant. In doing so, the FSM should use a common or unified format wherever possible.	Never submitted.
		The FSM shall have 60 days from the date of grant award to identify the amounts, sources, and the specific strategic focus and activities of all noncompact funding and direct technical assistance that relates to this sector.	Met.
		The FSM shall submit within 180 days from the date of grant award a streamlined and refined statement of outcome measures, baseline data, and annual targets to enable the tracking of outputs and outcomes. In doing so, the FSM should use a common and unified format wherever possible. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the FSM submits for 2005 funding.	Never submitted.

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<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		As a condition precedent to the drawdown of funding for this specific activity, Chuuk shall provide written justification to OIA for the funding of \$100,990 for Marine Resources.	Justification was provided, and the funding was released.
	2005	<p>These activities listed below require additional written justification that they are in line with the sector grant's mandated emphasis and guidelines. JEMCO conditionally approves the following, pending the submittal to OIA of sufficient information:</p> <ul style="list-style-type: none"> <li>• National Government: Archives and Historic Preservation</li> <li>• Chuuk: Marine Resources, Agricultural Operations, and Historic Preservation Office</li> <li>• Yap: Roadside Maintenance and YAPCAP</li> </ul>	Justification was submitted, and the fiscal procedures agreement language was broad enough to encompass all of the agencies' core missions. Funding was released.
		The FSM has 30 days from the date of grant award to submit the appropriate performance measures and baseline data to OIA for all approved activities. The measures and data are to be specific to each funded activity, not for the sector as a whole.	Funding was held until performance measures and baseline data were eventually submitted, the information was extremely poor quality. However, no guidance was given or requested by OIA to the FSM for the development of the information.
	2006	The FSM shall not incur obligations against this grant until OIA has approved all proposed budget line items for the national government and its subgrantees.	OIA approved the budgets and released funds.
<b>Health</b>	2004	The FSM shall have 60 days from the date of grant award to realign this sector budget so that activities and related costs are clearly identified for each funding input under the grant. In doing so, the FSM should use a common or unified format wherever possible.	Partially met. According to OIA, while the numbers added up, the connection between activities and costs, and the relationship between costs to expected outputs—or how outputs linked back to the FSM's strategic goals and stated performance outcomes—remained unclear.
		The FSM shall have 60 days from the date of grant award to identify the amounts, sources, and specific strategic focus and activities of all noncompact funding and direct technical assistance that relates to this sector.	Met.
		The FSM shall submit within 180 days from the date of grant award a streamlined and refined statement of outcome measures, baseline data, and annual targets to enable the tracking of outputs and outcomes. In so doing, the FSM should use a common or unified format wherever possible. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the FSM submits for 2005 funding.	Partially met. According to OIA, statements of outcome measures were revised and submitted but work was still required to make the FSM's intent and targets clear. There were also problems related to having a common baseline year and using and providing information in a unified and common format.
		The FSM shall have until September 30, 2006, to obligate the carryover funds from 2004.	According to OIA, obligations are in process.

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<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		Consistent with the resolution adopted by JEMCO on August 2004, funds made available through this award may only be used for health-related infrastructure expenditures and are subject to conditions applicable to the public infrastructure grant. Such allowable uses include facility upgrades, renovation and repair, and fixed equipment and other capital assets.	The list of projects and purchases received by OIA complied with the resolution.
		The FSM Office of Compact Management shall compile a list of proposed related infrastructure expenditures identified by the FSM National Department of Health, Education, and Social Affairs and by Chuuk, Pohnpei, and Yap to be funded under this grant. The list shall be submitted to OIA's Honolulu Field Office for review and concurrence by November 30, 2005. No expenditures shall be allowed prior to that review, unless specifically approved by OIA.	OIA communicated directly with Chuuk, Pohnpei, and Yap and notified the Office of Compact Management that the lists were acceptable. The deadline was extended because the grant award was not signed by the FSM until December 19, 2005, due to a technical (nonsubstantive) error. This error was not brought to OIA's attention for correction until after the deliverable's due date.
	2005	The FSM shall have 30 days from the date of grant award to provide information on the three health insurance programs in existence for national and state government employees. At a minimum, this information should include (1) a breakdown of costs associated with the programs in Chuuk and Pohnpei; (2) the numbers served by each of the three programs; (3) eligibility requirements; (4) the basis for calculating premiums and/or government subsidies; and (5) capitation payments to private providers, state hospitals, and, as applicable, off-island tertiary care facilities.	The required information was provided, but its emphasis was on the FSM national government's program. OIA asked for and received clarification on Chuuk and Pohnpei's programs as well.
		The FSM shall have until April 1, 2005, to complete a comprehensive evaluation of the effectiveness of existing primary care systems and expansion plans in all four states. The study shall give specific emphasis on dispensaries, community health centers, and rural health and cover the following areas: (1) dispensary staffing, (2) communications, (3) referrals, (4) infrastructure, (5) transportation, (6) the procurement and distribution of medicines and other essential supplies, and (7) new and in-service training. The responsible agency for the evaluation shall be the FSM National Department of Health, Education, and Social Affairs (HESA) in consultation with the four state departments of health.	The FSM submitted an acceptable evaluation of its existing primary care systems and expansion plans for all four states on time, and provided an oral report to JEMCO at the August 2005 meeting in Pohnpei.
		HESA shall have 30 days from the date of grant award to submit an implementation plan and scope of work to OIA before going forward with the study.	Deadline was extended by OIA and met by the FSM.

**Appendix VI  
FSM Compliance with Special Sector Grant  
Terms and Conditions**

(Continued From Previous Page)

<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		The FSM has 30 days from the date of grant award to reprogram \$4,391 earmarked for Chuuk's Department of Education to a purpose specifically linked to the state's Department of Health Services.	Met.
		The FSM has 30 days from the date of grant award to reprogram \$11,500 earmarked for agricultural programs of Yap's Department of Resources and Development, to either nutrition education or another program activity directly managed by the state's Department of Health Services.	Met.
		No money shall be used by the FSM National Department of Health, Education, and Social Affairs for either building new facilities or renovating existing buildings. The findings of any physical assessment of health facilities funded under this grant shall be submitted to OIA no later than 90 days before the end of the grant period and also to the infrastructure development planning committees in all four FSM states.	Met.
		By April 15, 2005, the FSM national government and Chuuk, in consultation with OIA, shall develop an outline of a plan that shall promptly address the deficiencies found in the Chuuk health dispensary program. The completed plan shall be transmitted to OIA by May 15, 2005.	An acceptable plan was developed in consultation with OIA and submitted on time. A verbal report on the plan's implementation was accepted by JEMCO at its August 2005 meeting in Pohnpei.
	2006	The FSM shall not incur obligations against this grant until OIA has approved all proposed budget line items from the national government and its subgrantees.	OIA gave its approval at the start of the fiscal year.
		The FSM shall have 180 days from the date of grant award to submit information to OIA on (1) the common year selected by the National Department of Health, Education, and Social Affairs and all four state health departments that shall serve as the base for evaluations of sector grant performance and (2) data collected from that baseline year for all appropriate outcome measures described in the health care chapter of the FSM Strategic Development Plan. The submission shall also include 2004 data linked to these performance measures.	The FSM health directors met in September 2005 and agreed to use 2004 as the baseline year. At that time, they established a process to review the strategic goals and outcome measures in the FSM's development plan. In January 2006, they met again and reaffirmed their previous selection of 10 outcome measures and added 4 more measures. The FSM national government also began collecting baseline data.
		The FSM shall have 180 days from the date of grant award to submit the appropriate actual performance targets for 2006 and prospectively for 2007 and 2010.	The health directors established medium-term targets for 2010 but did not meet the condition to submit actual performance targets for 2006 or prospectively for 2007. According to OIA, the FSM health directors were confused about the requirement.
<b>Infrastructure</b>	2004	No grant funds may be expended or obligated before an infrastructure development plan (IDP) is developed by the FSM and submitted to OIA for review.	Not met in 2004.

**Appendix VI  
FSM Compliance with Special Sector Grant  
Terms and Conditions**

*(Continued From Previous Page)*

<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		To the extent that the infrastructure priorities in the IDP differ materially from those set forth in the FSM Infrastructure Development Plan prepared by Nathan Associates, Inc., written justification should be provided to OIA for concurrence.	Not met in 2004.
		An amount equal to 5 percent of the total grant must be placed in a separate bank account (the Infrastructure Maintenance Fund (IMF)), which upon deposit by the FSM will be matched by OIA. Funds in this account may be used for operations and maintenance needs once an IMF plan has been developed and submitted by the FSM and approved by OIA.	Not met in 2004.
	2005	JEMCO resolves that infrastructure investment for 2005 should move toward being funded at no less than 30 percent of annual compact grant funding, consistent with the sense of Congress, and shall achieve that level for 2006.	Met.
		JEMCO resolves that OIA shall approve no projects until JEMCO has granted its concurrence in compact-funded portions of the FSM's Infrastructure Development Plan.	Met.
		JEMCO resolves that OIA shall deem approved no projects until the FSM national government has provided OIA with, and OIA has approved, a consolidated list of projects in order of national priority consistent with the IDP concurred by JEMCO.	Not met in 2005.
		JEMCO resolves that as part of the justification of each infrastructure project, the FSM national government shall demonstrate that the project implementation shall be professionally managed.	Met.
		JEMCO allocates from the infrastructure sector the amount of \$1 million for the initial establishment of a project management unit.	Met.
		JEMCO resolves that by August 31, 2005, the FSM national government shall conduct detailed planning studies to determine the infrastructure requirements of the health and education sectors.	Not met in 2005 —extended to January 31, 2006, by JEMCO resolution. Extension of its deadline also was not met by the FSM.
	2006	An amount equal to 5 percent of the total grant must be placed in a separate bank account, the IMF, which upon deposit by the FSM, will be matched by OIA. Funds in this account may be used for maintenance needs once an IMF plan has been developed and submitted by the FSM and approved by OIA.	Not met as of August 2006.

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FSM Compliance with Special Sector Grant  
Terms and Conditions**

(Continued From Previous Page)

Sector	Fiscal year	Special terms and conditions in sector grants	Status according to OIA
<b>Private Sector Development</b>	2004	The FSM shall have 60 days from the date of grant award to realign this sector budget so that activities and related costs are clearly defined for each funding input under the grant. In doing so, the FSM should use a common or unified format wherever possible.	Never submitted.
		The FSM shall have 60 days from the date of grant award to identify the amounts, sources, and the specific strategic focus and activities of all noncompact funding and direct technical assistance that relates to this sector.	Met.
		The FSM shall submit within 180 days from the date of grant award a streamlined and refined statement of outcome measures, baseline data, and annual targets to enable the tracking of outputs and outcomes. In doing so, the FSM should use a common and unified format wherever possible. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that FSM submits for 2005 funding.	Never submitted.
		Funding under this grant shall not be used by Yap for the Visitor's Bureau unless OIA approves a reprogramming request.	Yap submitted a revised budget and received approval for funding the Visitor's Bureau.
		Included within this grant is \$888 for Yap to use for Resources and Development.	In accordance with the condition, Yap budgeted the funding for Resources and Development.
		As a condition precedent to the drawdown of funding for this specific activity, Kosrae shall provide written materials to justify the request for \$152,000 for the funding of Livestock Research/Tissue Culture.	Justification was provided, and the funding was released.
		As a condition precedent to the drawdown of funding for this specific activity, Kosrae shall provide written materials to justify the request for \$205,000 for the funding of the Mangrove Crab Project.	Funding was released.
		Within 6 months, the FSM will develop a transition plan to migrate basic operations funding from compact sector grants to local revenues. This plan will provide for this migration to happen over a period not to exceed 5 years and in amounts no less than 20 percent of the totals in each year, unless otherwise mutually agreed. The following amounts will be included in the transition plan: <ul style="list-style-type: none"> <li>• Chuuk: \$918,242</li> <li>• Kosrae: \$240,132</li> <li>• Pohnpei: \$335,781</li> <li>• Yap: \$319,136</li> </ul>	The FSM contested the notion of a phase-out plan for the private sector development grant and planned to discuss the issue further at the next JEMCO meeting. OIA sent a letter agreeing to release the funds, and the issue was dropped.

**Appendix VI**  
**FSM Compliance with Special Sector Grant**  
**Terms and Conditions**

(Continued From Previous Page)

Sector	Fiscal year	Special terms and conditions in sector grants	Status according to OIA
	2005	<p>JEMCO approves the following grants once adequate written justification is provided to OIA. The grants were for:</p> <ul style="list-style-type: none"> <li>• Chuuk: Commerce and Industry, Marine Resources, and Agriculture</li> <li>• Pohnpei: Economic Development Authority</li> <li>• Yap: Resources and Development</li> </ul> <p>The FSM has 30 days from the date of the grant award to submit the appropriate performance measures and baseline data to OIA for all approved activities. The measures and data are to be specific to each funded activity, not for the sector as a whole.</p>	<p>Justifications were submitted. The fiscal procedures agreements language is broad enough to encompass all agencies' core missions. Funding was released.</p> <p>Funding was held until performance measures and baseline data were submitted. When performance measures and baseline data were eventually submitted, the information was of extremely poor quality. However, no guidance was given by OIA or requested from the FSM for the development of the information.</p>
	2006	None.	
<b>Public Sector Capacity Building</b>	2004	The FSM shall have 60 days from the date of the grant award to realign its budget so that activities and related costs are clearly defined for each funding input. In doing so, the FSM should use a common or unified format wherever possible.	Partially met. According to OIA, while the numbers added up, the connection between activities and costs, and the relationship between costs to expected outputs or how outputs—linked back to the FSM's strategic goals and stated performance outcomes—remained unclear.
		The FSM shall have 60 days from the date of the grant award to identify amounts, sources, and the specific strategic focus and activities of all noncompact funding and technical assistance that relates to this sector.	Met.
		The FSM shall submit within 180 days from the date of the grant award a streamlined and refined statement of outcome measures, baseline data, and annual targets to enable the tracking of outputs and outcomes. In doing so, the FSM should use a common or unified format wherever possible. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the FSM submits for 2005 funding.	Not met. The public sector capacity building grant does not contain any conforming, unified outcome measures; baseline data; or annual targets.
		As a condition precedent to the drawdown of funding of \$122,698, Chuuk shall hire a qualified public auditor.	Chuuk has not yet hired a qualified public auditor.

**Appendix VI  
FSM Compliance with Special Sector Grant  
Terms and Conditions**

(Continued From Previous Page)

Sector	Fiscal year	Special terms and conditions in sector grants	Status according to OIA
		<p>Within 6 months, the FSM will develop a transition plan to migrate basic operations funding from the public sector capacity building sector grant to local revenues. The plan will provide for this migration to happen over a period not to exceed 5 years and in amounts not less than 20 percent of the totals in each year, unless otherwise mutually agreed. The following amounts will be included in the transition plan:</p> <ul style="list-style-type: none"> <li>• Chuuk: \$2,741,115</li> <li>• Kosrae: \$909,187</li> <li>• Pohnpei: \$1,457,080</li> <li>• Yap: \$1,726,367</li> <li>• National government: \$3,782,175</li> </ul>	<p>The plan was late, and funds were temporarily withheld.</p>
	2005	<p>The FSM had 30 days from the date of the grant award to submit the appropriate performance measures and baseline data to OIA for all approved activities. The measures and data are to be specific to each funded activity, not for the sector as a whole.</p>	<p>No submittal from the FSM.</p>
		<p>JEMCO confirms the decision by the Anticipatory Task Force in August 2003 to require a transition plan of nonconforming expenses out of the public sector capacity building grant over a 5-year period and agrees, except to the extent otherwise provided by the foregoing resolution, to the schedule to which the FSM government has committed from the implementation of that transition plan for all five FSM governments. The schedule is as follows:</p> <ul style="list-style-type: none"> <li>• Within 6 months, the FSM will develop a transition plan to migrate basic operations funding from the public sector capacity building grant to local revenues. This plan will provide for this migration to happen over a period not to exceed 5 years.</li> </ul>	<p>A schedule was submitted that showed the reduction of public sector capacity building revenues going to basic operations funding, but not how it would be replaced by local revenue.</p>
	2006	<p>None.</p>	

Sources: FSM sector grant agreements for 2004 through 2006 and OIA compliance updates.

# RMI Compliance with Special Sector Grant Terms and Conditions

Sector	Fiscal year	Special terms and conditions in sector grants	Status according to OIA
Education	2004	The RMI shall have 60 days from the date of grant award to realign its budget so that activities and related costs are clearly defined for each funding input. The category, "U.S. and Other Grants," shall list components and allowable uses.	Met.
		The RMI shall submit within 180 days from the date of grant award a streamlined and refined statement of performance measures, baseline data, and annual targets to enable the tracking of goals and objectives. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the RMI submits for 2005 funding.	Met.
	2005	The RMI shall conduct three evaluation studies and performance assessments.	(1) An extension was requested. The deliverable was extended to 2006. An inventory of 71 of 80 schools was received on July 21, 2006. The remaining 9 schools' inventory is required in the first quarter of 2007.
		(2) Within 180 days from the date of the grant award, an analysis of school year 2004-2005 staffing patterns will be submitted and include, but not be limited to, the number of students enrolled as of October 1, 2004; the number of staff by category (principals, vice-principals, teachers, teacher assistants, specialists, support staff, etc.) as of October 1, who are full-time and part-time employees; changes in staffing from school year 2003-2004; the number of staff in each category in each school; and the October 1 student-to-teacher ratio.	(2) A summary document was received. A revision was requested to meet the requirement for select data by school, not in summary format. The revision was received in the Fall of 2005.
		(3) Within 180 days from the date of the grant award, an evaluation of the effectiveness of the national student testing systems will be conducted and progress to date submitted. The third and sixth grade national testing instruments will be evaluated for validity and alignment to national standards and curricula. An eighth grade testing instrument will be designed.	(3) An extension was requested, and was granted. The deliverable was extended to 2006.

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RMI Compliance with Special Sector Grant  
Terms and Conditions**

*(Continued From Previous Page)*

<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		The RMI shall provide data of educational progress no less than annually, in time for submittal to JEMFAC. At a minimum, data on the 20 indicators of educational progress discussed at the August 13th JEMFAC meetings will be gathered and submitted no later than July 1, 2005. Quarterly performance reports must include completed data charts, effective immediately, and incorporate the 20 indicators of educational progress no later than July 1, 2005.	The majority of the 20 indicators were submitted on time. The outstanding 5 indicators were requested but not received.
		The RMI shall routinely submit to the OIA Honolulu Field Office one copy of all educational studies, surveys, and performance evaluations completed with education sector or Supplemental Education Grant funds.	Some locally developed reports are routinely submitted to OIA. Other reports are not routinely submitted but are identified in quarterly reports, which OIA then requests.
	2006	Quarterly financial and performance reports shall include completed data charts, data on Ebeye Special Needs expenditures and activities, and copies of all reports completed with education sector or Supplemental Education Grant funds.	The quarterly reports were received on time and included information specific to Ebeye. However, data charts embedded in the RMI format were often incomplete. Other reports completed with compact or Supplemental Education Grant funds are occasionally but not routinely transmitted to OIA.
		All 20 indicators of educational progress shall be reported by July 1st annually.	Received July 28, 2006.
		The Government of the Republic of the Marshall Islands shall complete the textbook and staffing inventories by October 31, 2005.	(1) An extension was requested for the textbook inventory.  (2) The staffing inventory was received by the deadline.
		The Government of the Republic of the Marshall Islands shall spend those monies required, up to \$100,000, to conduct the mandated national evaluation of the effectiveness of the national student testing systems by a reputable testing and evaluation expert within 180 days of the grant award, and to conduct other evaluations and assessments as needed. These monies shall come from the education sector grant award, unless available from other sources.	According to OIA, the national student testing system is in near final form. The RMI brought in a consultant to review and validate its new testing system. The consultant provided a minimal assessment of the testing system to the RMI. The RMI shared with OIA. OIA requested a more thorough analysis, but the RMI did not provide this by the end of school year 2005-2006. This grant condition will continue into 2007.
<b>Environment</b>	2004	The RMI shall have 60 days from the date of grant award to realign its budget so that activities and related costs are clearly defined for each funding input. The category, "U.S. and Other grants," shall list components and allowable uses.	Never submitted.

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RMI Compliance with Special Sector Grant  
Terms and Conditions**

*(Continued From Previous Page)*

<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		The RMI shall submit within 180 days from the date of the grant award a streamlined and refined statement of performance measures, baseline data, and annual targets to enable the tracking of goals and objectives.	Never submitted.
	2005	The RMI shall deliver to OIA the appropriate performance measures and baseline data for all approved activities by November 30, 2004.	The RMI submitted revised portfolios.
	2006	The grantee shall submit a written explanation of each budgeted activity no later than 30 days after the date of grant award.	The RMI submitted revised portfolios.
		<p>The following performance measures shall be reported on quarterly:</p> <ul style="list-style-type: none"> <li>• Percentage of safe public water supply in Majuro</li> <li>• Percentage of coastal water tests deemed safe</li> <li>• Total conservation areas in the Republic of the Marshall Islands</li> <li>• Percentage of safe outer island water supply</li> <li>• Percentage of dead and endangered reef areas</li> <li>• Total number of solid waste violation per quarter</li> </ul>	The deadline is the end pf 2006. According to OIA's environmental grant manager, the RMI is expected to submit all 6 indicators by the deadline.
<b>Health</b>	2004	The RMI shall have 60 days from the date of the grant award to realign its budget so that activities and related costs are clearly defined for each funding input. The category, "U.S. and Other Grants," shall list component and allowable uses.	Partially met. Soon after the grant was awarded, OIA worked closely with the RMI's consultant on performance budgeting, and with the RMI's Economic, Policy Planning Statistics Office and Ministry of Health, on addressing the grant's budget realignment requirements. The results were evident in improvements to the first and subsequent quarterly reports in 2004 and the 2005 budget submitted to OIA. Although the requirement was directed to the Ministry of Health, the condition had a beneficial spillover effect in improving reporting and performance budgeting for all compact grant sectors. In retrospect, the deadline imposed in the grant may have been premature since the realignment process required time and effort beyond the 60-day framework and is still continuing.

**Appendix VII  
RMI Compliance with Special Sector Grant  
Terms and Conditions**

*(Continued From Previous Page)*

Sector	Fiscal year	Special terms and conditions in sector grants	Status according to OIA
		<p>The RMI shall submit within 180 days from the date of grant award a streamlined and refined statement of performance measures, baseline data, and annual targets to enable the tracking of goals and objectives. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the RMI submits for its 2005 funding.</p>	<p>Partially met. The RMI reduced the number of performance measures it tracks to those that primarily relate to effectiveness and efficiency, and ensured its annual targets were output oriented. In retrospect, the deadline imposed in the grant may have been premature since the realignment process required time and effort beyond the 180-day framework and is still continuing.</p>
		<p>Insofar as possible, performance measures should apply equally to both Majuro and Ebeye health subsystems, and baselines should reflect differences in health status and service levels in the two urban centers. Measures of disease incidence or prevalence should also be developed to gauge the impact of environmental and infrastructure improvements on health status.</p>	<p>Soon after the grant was awarded, OIA worked with the RMI's consultant on performance budgeting and with RMI's statistics office to improve the consistency of performance budgeting between Ebeye and Majuro. According to OIA, the reporting has improved and is reflected in the 2005 and 2006 budgets submitted to OIA. Measures of disease incidence and prevalence, however, still do not adequately track environmental conditions. The RMI, however, is working to improve its health status statistics. Education and health infrastructure projects were the RMI's priority in 2004 and 2005.</p>
	2005	<p>The RMI shall have 90 days before the end of the grant period to complete a comprehensive evaluation of the effectiveness of its existing primary health care system and expansion plans. No less than 1 percent of the total grant award shall be set aside for this purpose.</p>	Met.
		<p>The RMI shall have 30 days to submit an implementation plan and scope of work to OIA before implementing the study.</p>	Met.
		<p>Up to a maximum of \$100,000 in carryover funding from the 2004 health sector grant shall be used to continue the provision of technical assistance in performance budgeting and measurement. The scope of work shall focus on refining outcome statements, measures, and baselines that demonstrate the effectiveness or efficiency of the Ministry of Health's interim outputs.</p>	<p>The 2004 carryover grant awarded to the RMI provided funds to continue the provision of technical assistance to build performance budgeting and monitoring capacity.</p>
		<p>No grant funds may be used by agencies outside the health sector or for general government administrative costs, unless specifically justified and preapproved by JEMFAC.</p>	<p>This condition was meant to prohibit any further levying of a percentage cost for the Office of the Auditor General as was done (and not disclosed) by the RMI during 2004.</p>

**Appendix VII  
RMI Compliance with Special Sector Grant  
Terms and Conditions**

*(Continued From Previous Page)*

<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
		The Ministry of Health shall have 30 days from the date of grant award to submit a list to OIA's Honolulu Field Office that describes the specific uses of funding provided under CSG-RMI-2006-C. Funds may not be used for recurring salaries and may not be used for other operating costs, except as approved by OIA.	Partially met. The Ministry of Health notified OIA of its intent to use most of its carryover funds to support the continuation of performance budgeting technical assistance. This notification was within the 30-day time frame. The remaining funds were to go to Majuro Hospital, but specific uses were not identified until August 2006.
	2006	None.	
<b>Infrastructure</b>	2004	The RMI shall submit a formal infrastructure development and maintenance plan to OIA prior to the expenditure of sector grant funds for construction activities.	Met.
		Funds designated for Infrastructure Maintenance Funds will be deposited after the RMI has transmitted its 2004 infrastructure maintenance plan to OIA for its concurrence in writing.	Met.
	2005	The RMI government shall formulate a project development plan, consistent with the Infrastructure Development Maintenance Plan format for the project entitled "Ebeye Hospital Repair."	No plan formulated as of September 13, 2006.
	2006	None.	
<b>Private Sector Development</b>	2004	The RMI shall have 60 days from the date of grant award to realign its budget so that activities and related costs are clearly defined for each funding input. The category, "U.S. and Other grants," shall list components and allowable uses.	Never submitted.
		The RMI shall submit within 180 days from the date of grant award a streamlined and refined statement of performance measures, baseline data, and annual targets to enable the tracking of goals and objectives. These materials shall form the basis for setting measurable annual targets for the sector grant budget and performance plan that the RMI submits for 2005 funding.	Never submitted.
	2005	The RMI shall deliver to OIA the appropriate performance measures and baseline data for all approved activities by November 30, 2004.	The RMI submitted revised portfolios.

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**RMI Compliance with Special Sector Grant**  
**Terms and Conditions**

*(Continued From Previous Page)*

<b>Sector</b>	<b>Fiscal year</b>	<b>Special terms and conditions in sector grants</b>	<b>Status according to OIA</b>
	2006	The following performance measures shall be reported on quarterly:  (1) Dollar amount of export revenues from local products. (Baseline will be established in 2006, and this measure will be used in future years to determine program development.)  (2) Number of international tourist arrivals.	Never submitted.
<b>Public Sector Capacity Building</b>	2004	None.	
	2005	The RMI shall deliver to OIA the appropriate performance measures and baseline data for all approved activities by November 30, 2004.	Never submitted.
	2006	The RMI shall deliver to OIA an audit work plan and audit schedule for 2006 by October 31, 2005.	Submitted late.

Sources: RMI sector grant agreements for 2004 through 2006 and OIA compliance updates.

# Comments from the Department of the Interior



## United States Department of the Interior

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



DEC 07 2006

Mr. David Gootnik  
Director  
International Affairs and Trade  
United States Government Accountability Office  
Washington, D.C. 20548

Dear Mr. Gootnik:

Thank you for the opportunity to review and comment on the Government Accountability Office (GAO) draft report entitled "Compacts of Free Association: Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability" (GAO-07-163). (Draft Report). The Department of the Interior (Department) agrees with the seven recommendations presented in the Draft Report with regard to the roles of the Department and other U.S. agencies in the joint economic management of the Compacts of Free Association.

We find the report to be accurate and well balanced. The Draft Report exhaustively details the challenges facing the Federated States of Micronesia (FSM), the Republic of the Marshall Islands (RMI), and the United States as we act as partners to make each compact successful. As the Draft Report makes clear, despite significant efforts, progress is not easily achieved in either of these two nations. The continuing shortfall of internal capacity to plan, budget, implement and report on the use of compact resources is a serious concern to the Department and to the freely associated states governments themselves.

We particularly appreciate that the Draft Report reflects an understanding that the compacts are bilateral agreements between nations, and that the Joint Economic Management Committee (JEMCO) and the Joint Economic Management and Financial Accountability Committee (JEMFAC) have limited authorities. Although both committees are important actors in addressing the Draft Report's recommendations, success depends more on bilateral cooperation within the JEMCO and the JEMFAC than on unilateral U.S. action.

The Department, both as grants manager, and through its representation on the committees, is committed to working with the freely associated states and other U.S. agencies to address the four recommendations concerning the FSM and the three recommendations concerning the RMI. Because three of the recommendations to each government are similar, and our responses to them essentially the same, they will be presented together.

#### **Recommendations-**

*To improve FSM/RMI grant administration, planning, and measurement of progress toward compact goals, and to ensure oversight, monitoring, and accountability for FSM/RMI compact*

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**Appendix VIII**  
**Comments from the Department of the**  
**Interior**

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*expenditures, we recommend that the Secretary of the Interior direct the Deputy Assistant Secretary for Insular Affairs, as Chairman of JEMCO and JEMFAC, to coordinate with other U.S. agencies on the committee in working with the FSMRMI national governments to take the following three actions:*

*Establish plans for sector spending and investment by the FSM/RMI national and FSM state governments that minimize any adverse consequence of reduced funding resulting from the annual decrement or partial inflation adjustment.*

We agree with this recommendation, but because the decrements and partial inflation adjustment are deliberately part of compact policy, the adverse consequences to be addressed first are in the priority sectors of education, health and infrastructure. The decrements and partial inflation adjustment were intended to stimulate the FSM and RMI to address reforms to their tax and budgetary policy, government structure and approach to economic development. The governments would need to do this, in theory, to maintain adequate program funding in the six compact sectors, and to fund other public services. The theory is correct, although neither government to date has taken sufficient action to address these problems in the short term.

The authorities of the JEMCO/JEMFAC are limited with regard to these policy issues, though the annual meetings will be used as a platform to promote sound policy outside the realm of the compact sectors. JEMCO/JEMFAC can affect macroeconomic policy only to the extent sector grant allocations touch on those issues. However, we have also entered into conversations with the International Monetary Fund and the Asian Development Bank and the governments to promote reform and sound economic and budget planning. Success will only come, however, when the governments recognize their best interests and implement policy reforms.

*Fully develop the mechanisms for measuring sector grant performance and collect complete baseline data to track progress toward development goals.*

We agree with this recommendation. The report notes the continued efforts made to develop and obtain baseline data and sector performance. Both the FSM and the RMI have used technical assistance and compact funding to improve their capacity to provide timely and meaningful information. JEMCO/JEMFAC can help address this problem by earmarking funds and conditioning receipt of sector funds on improvements in this area.

*Ensure that the quarterly performance reports contain reliable and verified program and financial information for use as a monitoring tool by the FSMRMI and U.S. governments.*

We agree with this recommendation. We recognize the importance of this information and are working with the governments to improve the quality of the submissions. The FSM has recently embarked on a project using local and international contractors to address performance budgeting and reporting problems. We continue to seek improved financial information, and have used the fiscal procedures audit provisions as a tool to generate more timely data delivery. We will continue to use withholding of funds when appropriate to compel collection and distribution of timely financial information.

There is one FSM specific recommendation:

*Evaluate the impact of the current FSM distribution between states and sectors on the ability of the nation to meet national goals or deliver services.*

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**Appendix VIII**  
**Comments from the Department of the**  
**Interior**

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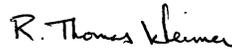
We agree with this recommendation. The United States has never formally recognized the FSM's formula to distribute compact funding, and notes the language in Section 211 which says that United States assistance under the compact shall constitute "a particular distribution...required by the terms or special nature of the assistance" for purposes of Article XII, section 1(b) of the Constitution of the FSM. This language means that allocation of Compact funding may be determined by JEMCO solely under terms of the fiscal procedures agreement. Nevertheless, the FSM is a sovereign country, and a partner in JEMCO and in the compact. We believe that the allocation of compact funds provided by the FSM should be respectfully considered, but ultimately evaluated by the results of the programs.

As the Draft Report states, there are large variances in per capita funding among the four FSM states. We agree that this bears scrutiny, and we are also concerned with the variance in performance that is reported and viewed. As more experience is gained in implementing the compact, and as information indicates that more or less funding should be provided to programs in a particular state, the JEMCO will not be constrained in making adjustments to fund allocations.

Finally, the Draft Report often notes the lack of capacity in both countries. Implementation of each recommendation requires that greater attention be paid by all parties to the Capacity Building Sector, especially in the FSM, to direct compact funding to ensure that planning, evaluating, measuring and reporting performance can be provided by the local governments.

Thank you again for the opportunity to comment on the Draft Report. If you have any questions concerning the response, please contact David B. Cohen, Deputy Assistant Secretary of the Interior- Insular Affairs, or Nikolao Pula, Director of the Office of Insular Affairs, at (202) 208-4736.

Sincerely,



R. Thomas Weimer  
Assistant Secretary

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

TELEPHONE (202) 223-4383  
TELEFAX: (202) 223-4391  
TELEX: 292003 FSME

December 4, 2006

Mr. David Gootnick  
Director, International Affairs and Trade  
United States Government Accountability Office  
441 G Street, NW  
Washington, D.C. 20548

Dear Mr. Gootnick:

The Government of the Federated States of Micronesia is grateful to the GAO for the opportunity to present the views of our government on the report entitled "**Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability**". We also take this opportunity to express our appreciation to the GAO staff for the time and effort that clearly went into the development of this report, and the overall level of commitment and resources that the GAO has dedicated to monitoring developments in our islands over the years.

The report, in our view, presents a balanced and fair assessment of our progress in planning for sustainability, measuring progress, and ensuring accountability. We agree with the overall conclusion that we face significant challenges in meeting the various amended Compact requirements. During the Consultative Group of Donors Meeting for the FSM held last month in Manila, the message from our government to our development partners emphasizes the development challenges that we face, particularly in implementing the amended Compact. We stressed to our donors our need for technical assistance to build the appropriate capacity to meet our development objectives, including and in particular Compact implementation. There is some overlap in the issues we raised with our donors and those raised here in the report.

Delay in use of infrastructure grant is one of the key issues. A land valuation assessment was completed under the Private Sector Development Loan from the ADB. The assessment recommended a framework for valuing land in each of the four FSM states. The government intends to build on this work to advance progress in addressing the important issue of access to land for infrastructure projects. Another important development that we expect will improve the ability of the government in managing infrastructure grants is the hiring of a qualified engineer to work in the Department of Transportation, Communications & Infrastructure (TC&I).

We also agree with the finding and recommendations regarding the need for developing the appropriate mechanism for tracking and monitoring performance. The FSM and the OIA Honolulu office have over the past year been in close consultation on ways to effect progress in measuring performance. Recent developments include the dedication of

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**Appendix IX**  
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public sector capacity building carryover grant funds from fiscal year 2004 and 2005 for funding activities that are specifically targeted at improvements in performance budgeting and reporting. With close consultation between the Office of Compact Management and the OIA Honolulu office, OCM is currently engaged in a project that will improve the budgeting and reporting framework in the FSM. This project involves linking the annual budgets to the FSM's Strategic Development Plan as well as improving the system currently in place for producing the quarterly performance reports.

Measures have also been taken to address the limited ability to monitor sector grant operations and accountability in general on use of Compact sector grants. In fact, the FSM has been working with OIA staff to develop and strengthen the accounting and other reporting requirements as mandated under the amended Compact and its related agreements, including the Fiscal Procedures Agreement (FPA). These efforts are showing results in the improving timeliness of the single audits. All the five FSM governments are up to date on their annual single audits up to the fiscal year ending September 30, 2005. Single audits for FY 2006 onward are expected to be completed on time. For FY 2006 audits, all five governments are concentrating on resolving all audit findings and questioned costs and have clean audits. Specifically for Chuuk, the government with the greatest number of audit findings and questioned costs, a joint effort has been initiated between the FSM government and OIA to have quarterly audits in order to improve compliance with laws, regulations and other requirements under the amended Compact.

A new Uniform Financial Management Information System (FMIS) has been implemented in the FSM with the main objective of improving the accounting and reporting capability of the FSM, especially in dealing with Compact funds. The new system has been installed and implemented in Yap and Pohnpei State Finance offices and will be implemented in the other states and the national government soon. It is estimated that all the governments will be on line with the new FMIS before the beginning of FY 2008.

Another development that will contribute to the overall improvement in the capacity of the FSM governments to meet amended Compact requirements is the Public Sector Capacity Building Roadmap project. Through ADB-funded technical assistance, a plan identifying training needs in the three focus areas—financial management, economic planning, and statistics— was developed in consultation with the five governments and is currently being implemented with assistance from an ADB follow-up TA. The national and states governments are strongly motivated to utilize Compact capacity building sector grant to fund implementation of the roadmap.

We generally agree with the set of GAO recommendations offered at the end of the report, and would look forward to working within the JEMCO structure and with the U.S. Agencies to achieve those goals. However, the FSM government must point out that the experience over the past three years with the amended Compact shows that minimizing the impact of declining compact grants and partial inflation adjustment is easier said than done. It is not something that will be overcome by mere planning. In fact, the planning already has been done. The need to achieve budgetary and economic self-reliance was the guiding principle for the development of the Sustained Growth Strategy (SGS) agreed

See comment 1.

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to during the 3<sup>rd</sup> FSM Economic Summit and documented in the Strategic Development Plan (SDP). The SGS entailed the FSM implementing a comprehensive set of reforms designed hopefully to ensure fiscal sustainability despite declining Compact grants and partial inflation adjustment by fostering private sector growth. In practice, the implementation of this strategic planning document is proving to be more time-consuming than had been anticipated, and it is becoming clear that further Compact adjustments will be necessary if the Compact's economic goals are to be reached.

Tax reform is a key component of the SGS. While the importance of streamlining public spending is recognized, emphasis is also accorded to improving the tax system in the FSM to improve tax revenue as well as encouraging private sector development. A growing tax base resulting from the implementation of measures to improve the investment climate is seen as a necessary basis for improving domestic revenue generation.

FSM is making encouraging strides on the tax reform front. We are now moving forward with implementation of the long discussed comprehensive tax reform. Development partners such as the IMF and the ADB have consistently indicated support for the FSM's comprehensive tax reform program. On the ground, a nation-wide policy level steering committee has been established and has held several meetings to discuss and reach certain policy decisions on the tax reform and a technical working group meets regularly to provide policy advice to the steering committee. The FSM government has committed funding for the operations of the tax reform unit, and the government is now actively seeking assistance from development partners for long-term technical support for the tax reform unit.

The GAO observations and recommendation regarding the impact of the distribution formula used in allocating compact sector grants among the five FSM governments touches on a very important issue for the FSM. The existing distribution formula is derived, with some adjustment, from the average of the various formulas used for allocating Compact I grants, which also allocated less funds on a per capita basis to the more populated states. In fact, the 70:30 principle applied to some of the Compact I funds allocated 70 percent of such grants by population and the remaining 30 percent equally regardless of population. The underlying principle supporting this approach is that while most government expenditures are based on population, there are certain fixed costs needed for running a government such as putting in place basic infrastructure like airports and seaports and having the minimum public service that must be met regardless of population. A decision to adopt a distribution formula that allocates compact sector grants fully on the basis of population would have been too drastic a step to take from the status quo. The current distribution formula was agreed to after years of debate and deliberation among national and state policy makers.

The FSM particularly welcomes the observation made by the GAO that we face significant challenges in implementing the amended Compact, given the new funding levels, new funding structure, and the new compliance and reporting requirements. Indeed, we recall that during the negotiations, we raised concerns on whether the new funding structure, compliance and reporting requirements might present too difficult a

See comment 2.

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**Appendix IX**  
**Comments from the Federated States of**  
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challenge for the FSM to be able to absorb. We pointed out at that time the greater magnitude of this challenge because of the FSM's broader cultural and federal structure.

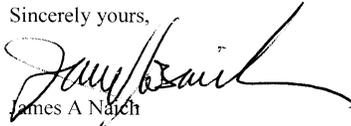
Nevertheless, the idea that prevailed in the negotiations, at the insistence of the U.S., is that such arrangements and requirements are necessary for the amended Compact and that only practice will tell how they perform. We left the negotiating table uncertain as to how and whether these new arrangements and requirements we were forced to agree to will actually work in practice, and most importantly whether we will have the capacity to make them work. FSM negotiators were assured at the time that the U.S. would keep an open mind, and indeed the Amended Compact contains much in the periodic review process that suggests flexibility in light of experience.

Progress continues to be made toward meeting compact compliance and reporting requirements, indicating good faith effort and commitment from the FSM. While we agree that there is room for further improvement in our capacity, the persistence of problems and challenges three years into amended Compact implementation is evidence there is room for re-evaluating the practicality of the new arrangement and requirements of the amended Compact. Such re-evaluation should be with a view to streamlining some of the compliance and reporting requirements, and determining whether funding levels are sufficient.

The only shortcoming that we might cite on the draft report is that while it provides a fair and thorough assessment of progress in implementing the amended Compact as is, there is no attention paid to assessing the amended Compact itself. This approach implies that there is no need for improvement in the amended Compact as presently being implemented. In this regard, we suggest that the U.S. Congress consider extending coverage of future GAO reports to an assessment of the amended Compact itself. Such an assessment should consider the practicality of the amended Compact with a view to assessing adequacy of funding as well as streamlining overly burdensome and unnecessary compliance and reporting requirements.

Again, the FSM expresses appreciation to the U.S. Congress and the GAO for its close attention to the progress of the FSM.

Sincerely yours,



James A. Natch

Charge d'Affaires Ad Interim

See comment 3.

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The following are GAO's comments on the Federated States of Micronesia's letter dated December 4, 2006.

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## GAO Comments

1. As we noted in both our June 2006 report<sup>1</sup> and this report, the FSM's efforts to address the decrement to date have not yielded the financial changes, including significant tax reforms, required to address the decrement. Therefore, we reiterate our position that the FSM needs to develop a plan to address the decrement. If the FSM fails to address the decrement, the federal and states' budgets will likely be reduced, making it difficult to maintain current personnel levels.
2. We recognize that the FSM established its 70:30 formula according to its stated goal of providing for certain needs common to each state, regardless of population size, such as the need for airports and seaports. However, the differences in per-capita funding resulting from use of the formula may have contributed to disparate conditions among the FSM states, especially in health and education, that cannot be ignored. These differences have also been identified by a Department of Health and Human Services official and in the FSM's own development plans as well as in a study by the Asian Development Bank. We believe that the formula's impact on each state's performance and development should be continuously evaluated and the allocation of funds revised as necessary. As we observe in this report, such an assessment requires the full development of the mechanism for measuring sector grant performance and collecting complete baseline data.
3. We testified three times in 2003, before the House and the Senate, regarding our assessment of the new arrangements and requirements of the amended compacts.<sup>2</sup>

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<sup>1</sup>GAO, *Compacts of Free Association: Development Prospects Remain Limited for Micronesia and the Marshall Islands*, [GAO-06-590](#) (Washington, D.C.: June 27, 2006).

<sup>2</sup>GAO, *Compact of Free Association: An Assessment of Amended Compacts and Related Agreements*, [GAO-03-890T](#) (Washington, D.C.: June 18, 2003).

# Comments from the Republic of the Marshall Islands

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



## *Republic of the Marshall Islands*

OFFICE OF THE CHIEF SECRETARY

P.O. Box 15

Majuro, Marshall Islands MH 96960

December 4, 2006

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

**Re: GAO Report "Compacts of Free Association: Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability"**

Dear Mr. Gootnick:

Thank you for providing the GAO Report (GAO-07-163) "Compact of Free Associations: Micronesia and the Marshall Islands Face Challenges in Planning for Sustainability, Measuring Progress, and Ensuring Accountability" (Draft) to the Government of the Republic of the Marshall Islands (RMI), and for allowing the RMI the opportunity to review and comment on the draft report.

**General Comments:**

The monitoring and reporting requirements, while agreed to by the RMI, were always anticipated to take a while to be able to be implemented. The RMI knew that it would take time to develop the capacity but agreed to the rigorous reporting requirements because it, too, wanted to be able to measure the performance of the Compact funding. Reporting is improving but it is recognized that the lack of capacity has meant that effective implementation of the monitoring and reporting requirements has taken longer than originally anticipated. While the Office of the Chief Secretary (OCS), the Economic Policy, Planning, and Statistics Office (EPPSO) and the Ministry of Finance (MOF) have this responsibility, these offices are also mindful of the need to set an example and not expand staffing levels,

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Mr. David Gootnick  
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when other Ministries are being asked to exercise restraint. Having said that, significant progress has been made on this issue.

**Specific Comments:**

**What GAO Found (Page 3)**

The GAO needs to recognize that the cited lack of sustainability is not unrelated to the view that part of the problems with reporting is due to lack of staff. Increasing staff will accentuate problems of sustainability. The important issue with respect to sustainability for the RMI is to restrain the cost structure of the civil service while improving services (outcomes) provided by the government. Part of the problem may also be that the reporting requirements of the Compact and the Fiscal Procedures Agreement (FPA) are very rigorous and it should be recognized that the RMI will struggle to meet the full letter of the reporting and monitoring requirements.

Since separate Compacts were agreed to, why does the GAO continue to report on FSM and RMI together? (See page 12)

Lack of FSM and RMI Planning for Decrement Threatens Sustainability of Government Services (Page 34)

The GAO continues to raise this issue. While the GAO correctly identifies that the real value of funds is declining there is no mention that the nominal value of grants will normally increase at normal levels of inflation. While prices will tend to rise over time, the government's revenue sources also tend to rise over time. As the price of imported goods rise, so will import duties, a major component of government revenues. The RMI's expenditure on imports is much smaller than expenditures on personnel.

The main concerns for the government are the increasing pressures from the growth in the government payroll, which squeezes operational expenditures. Management problems in State-Owned Enterprises (SOE's) have also placed increased expenditure pressures on the government budget.

The RMI acknowledges the need to improve the tax regime. However, in consultation with the private sector, the government has determined to focus on tax administration as the initial priority before addressing major reforms of the tax structure. The government recognizes that the tax structure is a major issue and has recommendations to address the situation but wishes to address these after the next election (due in November 2007) to allow time for the community to comment on the proposed changes before the following election.

The U.S. Compact of Free Association Amendments Act of 2003, U.S. P.L. 108-188 also makes provision for assessing and, if necessary, remedying adverse impacts caused by the decrement. Section 104(h)(2) provides that the U.S. Government shall review the terms of the U.S.-RMI Compact every five years and make this review a part of the President's report to

See comment 1.  
Now on p. 14.

Now on p. 31.

See comment 2.

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See comment 2.

Congress. The RMI is to be given the opportunity to comment on the review. This will provide an opportunity, starting in 2009, to examine the effect of the decrement and to make recommendations to address such concerns or problems.

In addition, the RMI maintained throughout the Compact re-negotiation process that the best way to deal with any negative effects of the decrement was to make provision for full inflation adjustment to the annual economic assistance listed in Section 217 of the U.S.-RMI Compact. Although inflation continues to be partially adjusted at the same rate as the original Compact, the Section 104(h)(2) review can make recommendations to adjust the inflation rate. See Section 104(h)(1)(E).

Furthermore, Section 104(j) provides that full inflation will apply starting in FY 2015 if the U.S. Gross Domestic Product Implicit Price Deflator average is greater for Fiscal Years 2009 through 2013 than the average for Fiscal Years 2004 through 2008.

Now on p. 34.

Countries Established Mechanisms for Measuring Performance, but Data Shortcomings Limit Ability to Assess Progress toward Goals (Page 37)

The RMI acknowledges that there are difficulties in measuring performance. It should be recognized that 2005 was only the second year of implementation and the measurement systems need time to develop especially where capacity in the line Ministries is lacking. The problems in the Ministry of Education (MOE) are being addressed by the exchange of staff between the MOE and EPPSO. In this way staff from EPPSO will be able to provide technical input into the performance measurements in MOE by boosting their statistical reporting capacity among other things. MOE staff working with EPPSO will receive a better appreciation of the reasons the data is needed for performance-based budgeting (PBB). Although the Ministry of Health (MOH) has demonstrated a greater ability to cope with the reporting requirements of the Compact, this approach will be pursued with MOH as well.

This is one reason why the RMI has decided to restrict its sector grants to the three sectors of education, health and infrastructure development and maintenance. The main reason is that these sectors are the government's priorities, but complementing this is the decision to develop the reporting and monitoring capacity in the relevant Ministries, since, as mentioned above, the reporting is dependent heavily on line Ministry capacity.

RMI Monitoring Was Limited, but Accountability Improved

Similar to the performance monitoring efforts listed above, the line Ministries are still developing familiarity with the detailed reporting requirements of the Compact. However, MOF has initiated a Finance Officers Committee, that meets regularly to help developed greater capacity in monitoring of Compact sector grants as well as other grant funding such as Federal program grants. MOF has also visited Ebeye to discuss all these issues with the government officials in Ebeye to ensure that all parts of the government are aware of the need for greater accountability and build capacity to cope with these requirements.

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As indicated, MOF has reduced the number of audit findings in recent years to a small number and aims to have an unqualified audit in the near future.

In conclusion, the RMI continues to welcome the GAO's input and looks forward to continuing to work with the GAO to identify and address issues of concern under the Compact of Free Association, as amended.

Sincerely,

[signed]  
Robert S. Muller  
Chief Secretary

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

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The following are GAO's comments on the Republic of the Marshall Islands' letter dated December 4, 2006.

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## GAO Comments

1. Throughout the report, we differentiate between the FSM and the RMI when discussing findings specific to each country. For example, when addressing land issues that have delayed projects in the countries, we discuss the issues and projects in each country separately. However, when findings were the same for both countries, we discussed the findings jointly. For example, we discuss planning for the decrement jointly because both the FSM and the RMI face the same issue.
2. The RMI projects that the annual inflation adjustment will allow the nominal value of annual grants to increase.<sup>1</sup> However, using the Congressional Budget Office's projections on the GDP Implicit Price Deflator, we found that for most years, the nominal value of the grants for the RMI declines each year from the previous years.<sup>2</sup> We believe that the RMI response does not capture the true impact of the decrement and the urgent need for sector grant planning to take it into account.

The combined impact of the decrement and partial inflation creates difficult challenges. First, absent full adjustment of the grants for inflation, the grants' real value declines, leading to reduced sector resources and creating challenges in recruiting and retaining agency staff.

- RMI government agencies will not be able to maintain the current levels of imported resources when the real value of grants decline. Imported items needed for the education and health sectors, such as textbooks and pharmaceuticals, are subject to rising external prices. Likewise, increasing costs of imported building supplies may reduce the purchasing power of the infrastructure grant.

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<sup>1</sup>Because of the difference between the FSM's and the RMI's decrements, although the nominal value of the RMI's grants generally drops each year from the previous year, the nominal value of the FSM's grants rises in most years.

<sup>2</sup>However, the RMI experiences a spike in funding in 2014, which temporarily increases the nominal value of the grants.

- In the RMI, personnel expenses are the largest area of government expenditures. Recruiting and retaining staff will be difficult if salaries are not fully adjusted for inflation. Furthermore, because RMI citizens can move to the United States to work, and many have done so, finding qualified personnel may become more difficult. A recent assessment of Marshallese emigration concluded that about one quarter of Marshallese now live abroad.<sup>3</sup>

Second, although the RMI states in its letter that it expects import duties to increase with external inflation, the inflation increase will not fully compensate for the decrements without aggressive growth in import duties.

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<sup>3</sup>Ben Graham, "Marshallese Out-Migration Intensifies," Pacific Islands Report Website of the East-West Center, University of Hawaii (available at [http://archives.pireport.org/archive/2006/November/graham\\_report.pdf](http://archives.pireport.org/archive/2006/November/graham_report.pdf)).

# GAO Contact and Staff Acknowledgments

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## GAO Contact

David Gootnick, 202 512-3149

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## Staff Acknowledgments

In addition to the individual named above, Emil Friberg, Assistant Director; Julie Hirshen; Ming Chen; Tracy Guerrero; Emmy Rhine; and Eddie Uyekawa made key contributions to this report. Joe Carney, Etana Finkler, Mary Moutsos, and Reid Lowe provided technical assistance.

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# Related GAO Products

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*Compacts of Free Association: Development Prospects Remain Limited for Micronesia and the Marshall Islands.* [GAO-06-590](#). Washington, D.C.: June 27, 2006.

*Compacts of Free Association: Implementation of New Funding and Accountability Requirements Is Well Underway, but Planning Challenges Remain.* [GAO-05-633](#). Washington, D.C.: July 11, 2005.

*Compact of Free Association: Single Audits Demonstrate Accountability Problems over Compact Funds.* [GAO-04-7](#). Washington, D.C.: October 7, 2003.

*Compact of Free Association: An Assessment of Amended Compacts and Related Agreements.* [GAO-03-890T](#). Washington, D.C.: June 18, 2003.

*Foreign Assistance: Effectiveness and Accountability Problems Common in U.S. Programs to Assist Two Micronesian Nations.* [GAO-02-70](#). Washington, D.C.: January 22, 2002.

*Foreign Relations: Kwajalein Atoll Is the Key U.S. Defense Interest in Two Micronesian Nations.* [GAO-02-119](#). Washington, D.C.: January 22, 2002.

*Foreign Relations: Migration From Micronesian Nations Has Had Significant Impact on Guam, Hawaii, and the Commonwealth of the Northern Mariana Islands.* [GAO-02-04](#). Washington, D.C.: October 5, 2001.

*Foreign Assistance: Lessons Learned From Donors' Experiences in the Pacific Region.* [GAO-01-808](#). Washington, D.C.: August 17, 2001.

*Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development.* [GAO/NSIAD-00-216](#). Washington, D.C.: September 22, 2000.

*Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands.* [GAO/RCED-00-67](#). Washington, D.C.: May 31, 2000.

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Washington, D.C. 20548

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U.S. Government Accountability Office, 441 G Street NW, Room 7149  
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