United States General Accounting Office

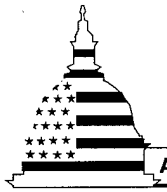
GAO

Report to Congressional Requesters

August 2001

FOREIGN ASSISTANCE

Lessons Learned From Donors' Experiences in the Pacific Region



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Accountability * Integrity * Reliability

GAO-01-808

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Abbreviations

ADB	Asian Development Bank
EU	European Union
FSM	Federated States of Micronesia
GDP	gross domestic product
OECD	Organization for Economic Cooperation and Development
RMI	Republic of the Marshall Islands
SWAps	sectorwide approaches
UNDP	United Nations Development Program
UNTA	United Nations Technical Assistance
USAID	U.S. Agency for International Development

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

August 17, 2001

The Honorable James V. Hansen
Chairman, Committee on Resources

The Honorable Tom Lantos
Ranking Minority Member
Committee on International Relations

The Honorable James A. Leach
Chairman, Subcommittee on East Asia and the Pacific
Committee on International Relations

The Honorable Doug Bereuter
House of Representatives

From fiscal years 1987 to 2001, the United States gave at least $2.6 billion[1] in economic assistance to the Federated States of Micronesia and the Republic of the Marshall Islands. A major portion of this assistance, about $1.7 billion, was provided under an international agreement, the Compact of Free Association. The Compact provided for assistance to the two Pacific Island nations over a 15-year period, starting in 1986. Currently, the United States is negotiating with the two countries to extend the economic assistance provisions of the Compact, which are set to end in late 2001. To address concerns that (1) the countries remain highly dependent on U.S. assistance; (2) the assistance has not significantly improved conditions in the countries; and (3) the expenditures have received little oversight, the U.S. negotiator is considering the use of different assistance strategies than those in the current agreements.

To assist the Congress in its review of the proposals for providing economic assistance that are under consideration in the negotiations, you asked us to identify useful lessons from the experiences of other donors in the Pacific. Specifically, we (1) identify the major donors of development assistance to the Pacific Island nations and their objectives, (2) discuss the

[1]Not adjusted for inflation. This figure does not include nuclear compensation-related assistance provided to the Republic of the Marshall Islands.

donors' development assistance strategies[2] and the factors or experiences that influence their choice of strategies, and (3) report lessons from the other donors' assistance strategies that could be useful for U.S. consideration.

For our review, we obtained and analyzed development assistance statistics for Pacific Island nations from 1987 to 1999. We collected and analyzed information on objectives, strategies, and development experience from donor agencies in Australia, Japan, New Zealand, the United Kingdom, and the United States and from the Asian Development Bank, the European Union, the United Nations Development Program, and the World Bank. (Further details about our objectives, scope, and methodology can be found in app. I.)

Results in Brief

Australia, Japan, New Zealand, the United Kingdom, and the United States have been the major providers of bilateral development assistance to the Pacific Island nations[3] since 1987.[4] The Asian Development Bank and the European Union have been the major multilateral donors. Of the $11.9 billion[5] in total assistance provided to the region from 1987 to 1999, the five bilateral donors have given 81 percent of the amount (of which the United States' share was 26 percent); the two multilateral donors have given 12 percent of the amount; and other donors have provided the remaining 7 percent. The donors' main development objectives, according to their planning documents, have been to alleviate poverty and to set the Pacific Island nations on the path to economic self-sufficiency. These

[2]We use the terms "development assistance strategy" and "assistance strategy" in this report to define the type of assistance. Donors use a variety of terms to define the kind of assistance they provide.

[3]These nations include the Cook Islands, the Federated States of Micronesia, Fiji, Kiribati, Nauru, Niue, Palau, Papua New Guinea, the Republic of the Marshall Islands, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu.

[4]We relied on information from the Organization for Economic Cooperation and Development (OECD) to identify the major donors. We recognize that other countries, such as China and Taiwan, which are not members of the OECD, also provide significant amounts of assistance. For example, according to *The Sidney Morning Herald* ("Pacific Region Enters a New Era of Shifting Alliances," May 24, 2001), China recently gave about $157 million to Papua New Guinea, which was nearly the same as Australia's annual assistance of about $167 million. We were not able to obtain assistance data directly from those countries.

[5]Adjusted to 1998 U.S. dollars. Unless noted, development assistance amounts are adjusted to 1998 dollars, which was the most recent inflation adjustment made by the OECD.

donors focus their assistance in key areas, such as education, policy reform, and infrastructure, to achieve these objectives. (See app. II for further details about the major donors, their objectives, and the recipients of their assistance.)

The major aid donors believe that many Pacific Island nations will not be able to achieve self-sustainability without continued assistance in the foreseeable future or will need assistance indefinitely. In addition, the donors acknowledge that there are important trade-offs involved in providing assistance to these nations. One important trade-off can occur when other objectives for providing assistance, such as foreign policy interests, place a different emphasis on the accountability or effectiveness of the development aid. There are also trade-offs between the administrative costs, effectiveness, and accountability of the assistance. In this context, the donors have explored and adopted the following different strategies and approaches to improve the effectiveness and efficiency of their assistance in the region:

- Five of the major donors have supported projects to improve governance in the recipient countries, such as developing a rule of law, as a foundation for effective development.
- One multilateral donor has adopted a subregional approach to development that tailors aid to the individual characteristics of recipients rather than applying the same strategy to all of the island nations.
- Two donors have built flexibility into their assistance strategies, which enables them to provide incentives for positive achievements or to stop assistance to recipients under undesirable conditions, such as political instability.
- Six of the major donors have relied on trust funds in the Pacific as a means of providing recipients with a self-sustaining source of future revenue.
- All of the major donors have emphasized donor coordination as a tool for improving efficiency by limiting duplication of projects and reducing the burden of multiple donor requirements on recipient countries.
- One major donor has adopted a sectorwide approach to assistance—a new approach in the Pacific region but widely discussed in development literature—as a pilot project in the health sector in an effort to encourage the recipient country to take ownership of the development process on a limited basis.

The United States could draw several lessons from the donors' experiences in the Pacific, in terms of the context for providing assistance to the region as well as the strategies and approaches the donors have adopted. These lessons could be valuable insights for the United States as

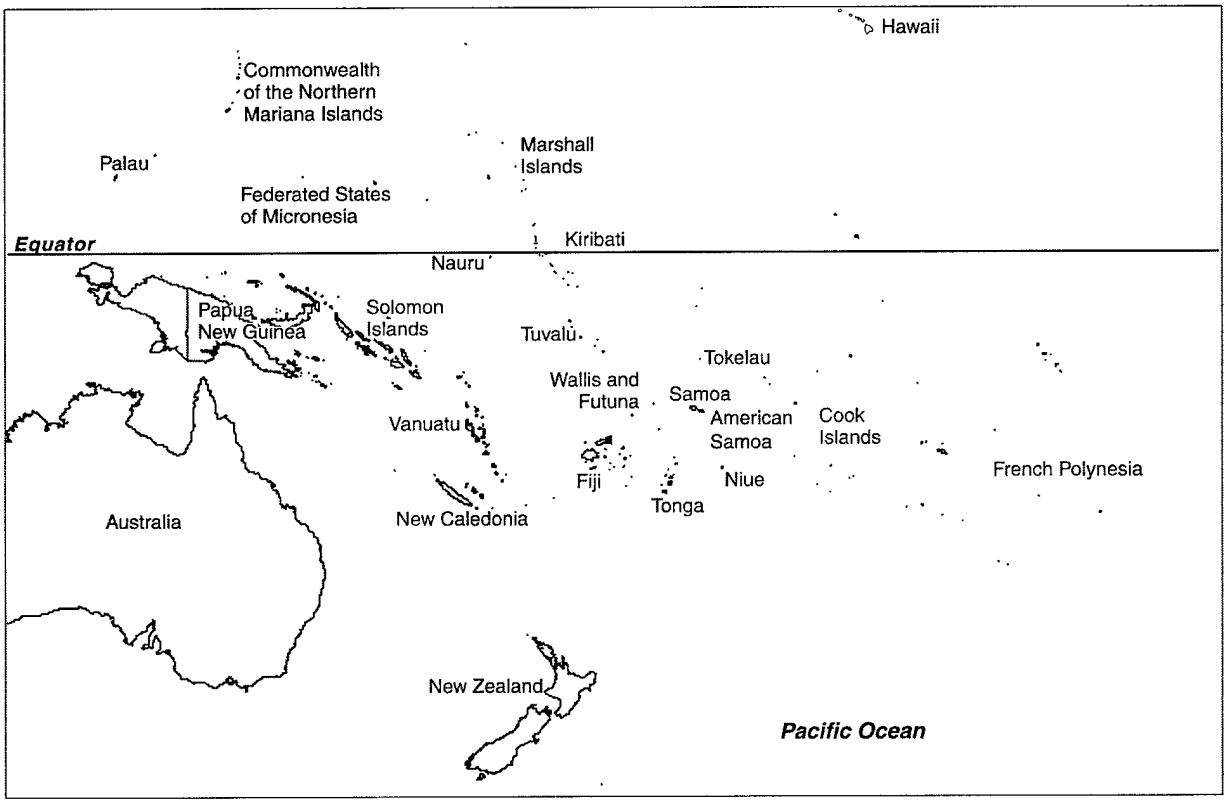
it negotiates additional economic assistance to the Federated States of Micronesia and the Republic of the Marshall Islands. For example, on the basis of the donors' experiences, we observed that

- assistance strategies may involve trade-offs in expectations of aid effectiveness if other objectives for providing assistance take priority over development objectives;
- assistance strategies also involve trade-offs between effectiveness and accountability, on the one hand, and administrative costs, on the other hand;
- effective assistance depends on a good policy environment in the recipient country to create the conditions for sustainable development;
- strategies tailored to the individual needs of the recipient country may have greater chances of succeeding because they offer, among other things, opportunities to the recipients for stronger ownership of the program;
- flexible strategies enable donors to adapt their assistance to changing circumstances and provide incentives for development achievements;
- well-designed trust funds can provide sustainable sources of assistance to Pacific Island nations with limited growth options; and
- sectorwide approaches, although generally untested in the Pacific, depend on recipient government commitment and ability.

Background

In general, the 14 island nations in the Pacific Ocean that we reviewed face significant development challenges. With few exceptions, such as Papua New Guinea and Fiji, the island nations have small economies and limited natural resources, and most are highly vulnerable to natural disasters, environmental problems, and the impacts of climate change. Their remote location, poor access to commercial and capital markets, and limited institutional capacity hinder economic development. In many islands, the public sector is disproportionately large, the private sector is poorly developed, and there is a shortage of trained personnel to meet development challenges. Finally, rapid urbanization, population growth, and inadequate infrastructure are outstripping the countries' ability to meet basic health and education needs. (See fig. 1 for a map of most of the island nations and territories in the Pacific region.)

Figure 1: Map of Pacific Island Nations and Territories



Source: GAO.

Virtually all of the Pacific Island nations, including the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI), receive development assistance. (See app. III for a description of the recipient nations and the assistance they receive.) In addition, at least seven island territories in the Pacific (including New Caledonia) receive direct government assistance from their associated governments and, in some

cases, a small amount of development assistance from other donors.[6] Five of the small island nations—Kiribati, Samoa, the Solomon Islands, Tuvalu, and Vanuatu—are "least developed countries," according to the United Nations, meaning that they have special development needs.

In 1986, the United States entered into a Compact of Free Association with the FSM and the RMI, both of which were part of the U.N. Trust Territory of the Pacific Islands administered by the United States. The United States agreed, in part, to provide economic assistance to these countries to help them in their efforts to become economically self-sufficient. A portion of the Compact assistance to the RMI is also used for payments to landowners related to the U.S. military presence at the Kwajalein Atoll. The Department of the Interior has responsibility for administering economic assistance to the two countries. This funding represented a continuation of U.S. financial support that had been supplied to these areas for almost 40 years after World War II. The two nations have also received support in the form of direct government services, such as U.S. Postal Service and National Weather Service assistance, and grants and loans from U.S. domestic agencies. From fiscal years 1987 through 2001, total U.S. support to the islands—Compact assistance and other U.S. assistance—is estimated at more than $2.6 billion.[7] The economic assistance provided to the two countries through the Compact of Free Association expires in late 2001. However, the Compact provides funding for an additional 2 years if negotiations on further assistance are not completed by that time.

In June 2000, the Department of State's negotiator for the Compact of Free Association testified that the general approach to the new negotiations

[6]The seven territories are American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, French Polynesia, New Caledonia, Wallis and Futuna, and Tokelau. In 1999, New Caledonia became an "outer country" of France as a step toward achieving full independence. The United States provides federal transfers to the Commonwealth of the Northern Mariana Islands, Guam, and American Samoa. In addition, the United States provided federal transfers to Palau as a territory until 1994, when it became an independent nation and began receiving U.S. assistance under the Compact of Free Association. France provides support to French Polynesia, New Caledonia, and Wallis and Futuna. New Zealand provides support to Tokelau. Other islands in the Pacific, such as Pitcairn, receive assistance but were not included in this review.

[7]Not adjusted for inflation, on the basis of our analysis and reported in *Renegotiation of the Foreign Aid Agreements With the Federated States of Micronesia and the Republic of the Marshall Islands*, which we submitted to the House Committee on Appropriations in April 2001.

with the FSM and the RMI includes sector grants and trust fund contributions, in place of the financial transfers provided in the first 15 years of the Compact, to improve accountability for the use of funds.[8] State concurred with our finding that the FSM, the RMI, and the United States provided limited accountability over Compact expenditures from 1987 to 1998.[9]

Major Aid Donors Provided About $11 Billion in Aid to Pacific Island Nations

From 1987 through 1999, the seven top donor countries and organizations provided about $11 billion, or 93 percent, of all development assistance to help Pacific Island nations. The bilateral donors generally targeted their assistance to a few recipients, while the multilateral donors distributed aid more broadly to member nations in the region.[10]

The Major Donors

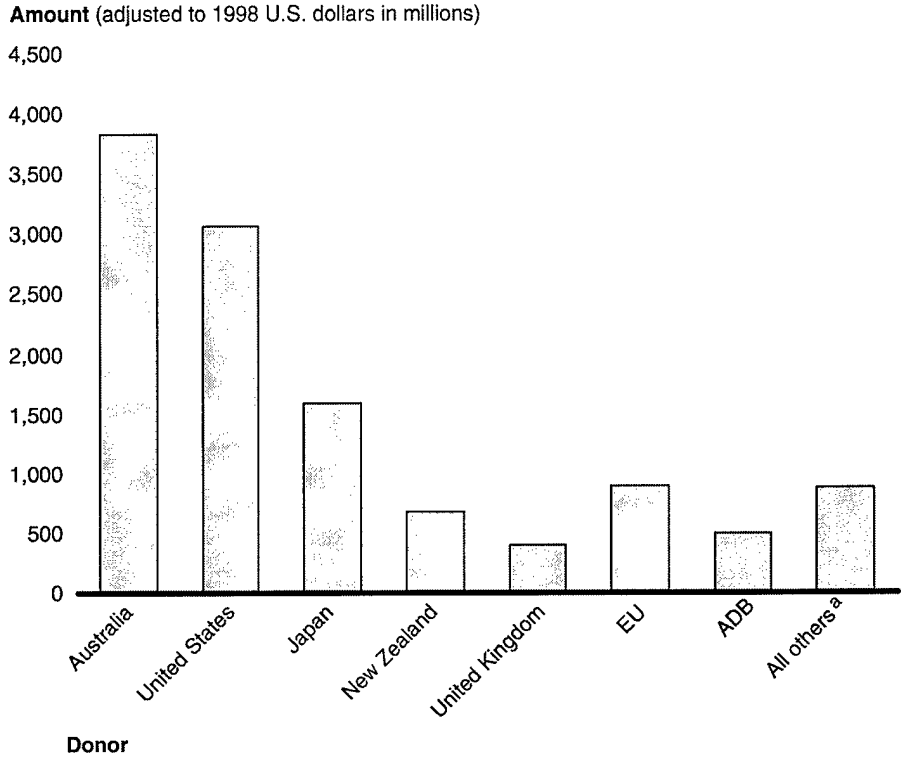
Five bilateral donors—Australia, Japan, New Zealand, the United Kingdom, and the United States—and two multilateral donors— the Asian Development Bank (ADB) and the European Union (EU)—provided about $11 billion in official development assistance to Pacific Island nations between 1987 and 1999, according to our review of data from the OECD and annual financial audits of the FSM, the RMI, and Palau. Figure 2 shows the top donors and the amount of total assistance provided to the Pacific region from 1987 through 1999.

[8]The United States has held four negotiating sessions with the FSM to discuss specific objectives.

[9]See *Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development and Accountability Over Funds Was Limited* (GAO/T-NSIAD/RCED-00-227, June 28, 2000) and *Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development* (GAO/NSIAD-00-216, Sept. 22, 2000). We reported that annual financial statements of the two countries did not provide information on the final use of Compact funds because the Compact monies are commingled with local revenues, and fund transfers are not tracked to the final use. The financial data also do not include additional assistance, such as loans to the government or individuals and scholarships to students.

[10]Other donors, such as China and Taiwan, are known to provide economic assistance, but the amounts are not readily available or reported to the OECD. Also, the data on development assistance levels do not include in-kind services, such as U.S. Postal Service support to the FSM and the RMI.

Figure 2: Total Development Assistance to the Pacific Island Nations, by Donor, 1987-99



[a]"All others" includes more than 29 other countries and international organizations.

Sources: GAO analysis of data from the OECD and financial audits for the FSM, the RMI, and Palau.

The major donor countries and organizations have varied widely regarding the development assistance provided to recipients from 1987 to 1999. The major bilateral donors, except for Japan and New Zealand, have concentrated their assistance on relatively few Pacific Island nations. For example, between 1987 and 1999, about 75 percent of Australia's assistance to the region went to Papua New Guinea, which is the largest country in the region, and about 91 percent of U.S. assistance went to the FSM, the RMI, and Palau. The multilateral donors also concentrated on a few recipients. The EU and the ADB gave about 65 percent and 55 percent of their assistance, respectively, to their top two recipients—Papua New Guinea and the Solomon Islands for the EU and Papua New Guinea and Samoa for the ADB. Two major donors, the United Kingdom's Department for International Development and the U.S. Agency for International

Development (USAID), significantly reduced their presence in the Pacific in the 1990s. The programs of two other donors, New Zealand and Japan, were under review in those countries at the time we prepared this report. The purpose of the New Zealand review is to examine how the development assistance program can best meet the long-term development needs of the recipients, given that most of the recipient countries will be dependent on aid indefinitely. The purpose of the program review in Japan is to look for opportunities to improve Japan's budget deficit.

Many Pacific Island nations are dependent on a single donor for most of their assistance. Seven of the 14 recipient countries received more than 50 percent of their aid from a single donor from 1987 through 1999. For example, the FSM and the RMI received 93 percent and 89 percent of their assistance, respectively, from the United States, according to our analysis. In addition, aid is concentrated between donors and recipients linked by free association agreements.[11] The five Pacific Island nations with free association status—the FSM, the RMI, and Palau, which are freely associated with the United States, and Niue and the Cook Islands, which are freely associated with New Zealand—received an average of 84 percent of their aid from their top donor, while the other seven recipients received an average of 37 percent of their aid from their top donor.

Major Donors' Objectives

According to documents of the major donors, their principal development objectives are to alleviate poverty in the region and help the island nations become more self-sufficient.[12] To achieve these objectives, Australia, for example, focuses its assistance in the Pacific on education and training, economic reform and governance, health, environment and natural resources, and private sector development. In 1998-99, Australia allocated 35 percent of its aid for education and training, 20 percent for economic reform and governance, 15 percent for health, 15 percent for environment

[11]"Free association" is a type of political relationship between sovereign nations. In the Pacific region, we found five Pacific Island nations with free association status. According to a State official, the concept of free association agreed to by the United States and Micronesia in 1978 was an agreement "through which a degree of external sovereignty is freely exchanged in return for a defense commitment and the promise of economic assistance."

[12]Currently, many recipients remain dependent on development assistance. For example, in 1998, aid comprised more than 35 percent of the gross domestic product of 5 of the 14 Pacific Island nations. In the FSM and the RMI, development assistance was 54 percent and 72 percent, respectively, of those nations' gross domestic product.

and natural resources, 5 percent for private sector development, and 10 percent for other areas. Similarly, to achieve its objectives, New Zealand supports projects around six strategies: security and governance, civil society, gender equality, social development, the environment, and business. Finally, as another example, the ADB is tackling poverty through promoting programs, such as public sector reform programs, in its Pacific member countries. Since 1995, the ADB has undertaken reform programs in seven Pacific Island nations for macroeconomic stabilization, good governance, public sector efficiencies, and private sector development.

Development Experiences Influence Donors' Choices of Assistance Strategies

The major donors recognize that their choice of assistance strategies must address long-term aid dependence by many Pacific recipients and trade-offs involving multiple objectives for assistance, costs, effectiveness, and accountability. Within this environment, the donors have tried several strategies to achieve their development objectives, such as incorporating flexibility and relying on trust funds. (See app. IV for further information on trust funds.)

Most Donors Expect Long-term Dependence on Assistance in the Pacific

Economic self-sustainability will be a difficult challenge for many Pacific Island nations and is not a realistic goal for the smaller and more remote countries, according to officials at and documents from the Australian Agency for International Development, the Japan Ministry of Foreign Affairs, the New Zealand Ministry of Foreign Affairs and Trade, and the ADB. The officials expect that, under the best circumstances, most countries will need assistance for the foreseeable future to achieve improvements in development. According to an ADB report,[13] "[I]t is widely understood that the smallest and least-endowed island states will need to be assisted by free transfers of resources indefinitely, if they are to maintain standards of welfare that the donors of the aid can bear to look at...."

Two major donors—the United Kingdom Department for International Development and USAID—chose to cut their bilateral programs significantly in the 1990s, due to changed priorities and agency budgetary reasons. The United Kingdom switched from a bilateral program to a regional program in 1995 that focused on three countries—Kiribati, the

[13]A.V. Hughes, *A Different Kind of Voyage: Development and Dependence in the Pacific Islands* (Manila, Philippines: Asian Development Bank, Feb. 1998).

Solomon Islands, and Vanuatu—where the need was greatest. According to a Department for International Development official at the regional office in Fiji, the United Kingdom now expects to end the regional program by 2004, as part of a worldwide change in the agency's focus, and will provide support to the region through multilateral donors. USAID ended its bilateral program in the South Pacific in 1994, due to agency budgetary reasons, and now provides modest assistance for a regional environmental program.

Multiple Motivations for Providing Assistance Have Led to Different Expectations for Aid Effectiveness

In providing assistance to the Pacific, most of the major donors combine their development interests with other motivations, according to officials and documents of the donor agencies. These other motivations include historic ties between the donor and the recipient (such as former dependencies), foreign policy interests, and strategic interests.[14] Australia's large commitment of assistance to Papua New Guinea, for example, responds to development needs in the country but also reflects the historical relationship and the development assistance program as agreed through a treaty with its former territory. For New Zealand, the development assistance program is one pillar of its foreign policy and is intended to contribute to stability and harmony in the South Pacific. Finally, U.S. assistance to the FSM and the RMI, through the Compact of Free Association, is one of three elements (political, economic, and defense) of the Compact. The defense element includes a right granted to the United States by the FSM and the RMI to deny access by third countries for military use.

While multiple motivations do not inherently conflict with development interests, other interests, in some cases, have taken precedence over the effectiveness and accountability of the development assistance. According to Australian, New Zealand, and State officials, for example, the donor countries initially chose to provide unrestricted budget support to former territories as a means of separating themselves from colonialist administration. In the case of the Compact with the FSM and the RMI, State counseled Interior to be lenient in reviewing the use of Compact funds in the early years of the Compact because State placed a high

[14]These multiple motivations are not unique to the Pacific. According to a study by Alberto Alsenia and David Dollar, *Who Gives Foreign Aid to Whom and Why?* (Cambridge, Mass.: National Bureau of Economic Research, June 1998), there is considerable evidence that aid donations are dictated by political and strategic considerations, such as historical ties and friendly voting records in the United Nations.

priority on maintaining friendly relations with the FSM and the RMI. By 1993, however, the United States began placing greater emphasis on the effectiveness and accountability of the assistance due, in part, to the end of the Cold War. Finally, according to Ministry of Foreign Affairs officials, Japan generally selects development projects from the requests of Pacific Island nations. The criteria for evaluating a specific request include, for example, the extent to which the project will be seen as a Japanese contribution but do not include an evaluation of the project need or sustainability.

Donors Also Strive to Balance Aid Effectiveness, Accountability, and Cost

In addition to recognizing that their development assistance may be intended to achieve multiple objectives, the donors have used a range of assistance strategies in striving to reach a desired balance of aid effectiveness, accountability, and administrative cost. The donors have used at least six different strategies to deliver their development assistance to the Pacific Island nations. These strategies include

- technical assistance, such as the ADB's funding of the economic advisory team in the FSM;
- project assistance, such as Japan's road improvement projects in the RMI;
- program assistance, such as the U.S. Department of Labor's job training program in the FSM;
- budget support, such as New Zealand's support for government operations in Niue;
- sectorwide programs, such as Australia's pilot program to support the health sector in Papua New Guinea; and
- contributions to trust funds, such as Australia's, New Zealand's, and the United Kingdom's contributions to the Tuvalu Trust Fund, which is intended to provide self-sustaining revenue.

These strategies often provide different levels of donor control over their assistance, according to officials with USAID, the New Zealand Ministry of Foreign Affairs and Trade, and the Australian Agency for International Development. Technical assistance and project assistance, for example, enable donors to exercise a high level of control and accountability by participating directly in funded activities, while unrestricted budget support and some forms of trust fund contributions allow donors little or no control over their assistance because the donor is only providing cash to the recipient. Reduced control over assistance is associated with more uncertainty in achieving the aid objectives and ensuring accountability. Yet, donors also acknowledge that the higher level of control involves greater administrative costs. Thus, there are trade-offs between donor control and costs, on one side, and expected effectiveness and

accountability, on the other. The following examples illustrate these trade-offs:

- New Zealand and Australia have cut the amount of budget support they provide as an assistance strategy in an effort to improve the effectiveness of their assistance. They found from their experience that (1) budget support did not achieve the intended development objectives and (2) these funds were largely unaccounted for. In 1997, New Zealand eliminated all of its annual budget support to the Cook Islands and focused on technical and project assistance after New Zealand found that the Cook Islands government was misusing funds and had built a large and inefficient public sector.[15] Similarly, the Australian Agency for International Development gradually eliminated its annual budget support to Papua New Guinea from 1990 to 2000 and replaced it with more than 100 separate project grants, because Australia could not identify specific development benefits linked to its cash transfer. At that time, Australia believed that project assistance, which it refers to as "jointly programmed activities," would give it more control over development activities. According to an Australian official, delivering budget support to Papua New Guinea required only 1 to 2 staff in 1990; but, by 2000-01, the Australian program supported more than 100 projects and required 73 staff from the Australian Agency for International Development, 30 Papua New Guinea staff, and at least 1 contractor for each project.
- The Australian Agency for International Development, the New Zealand Ministry of Foreign Affairs and Trade, and USAID have also faced trade-offs in adopting policies on the use of development assistance to pay for recurring expenses—that is, the annual government operations and maintenance costs—to improve the effectiveness of their aid. On the one hand, the donors are concerned that providing assistance for recurring expenses provides a disincentive to recipients to become more self-sufficient, and that recipients may choose to use assistance to pay for operating costs that are not related to development. The donors noted that recipients might decide to defer maintenance with the expectation that donor assistance will always be available. On the other hand, the donors are concerned that the projects they helped develop are not maintained or staff and supplies are not provided, and, thus, the assistance does not have a sustainable impact. The FSM, for instance, depends on U.S. assistance to

[15]The cut in budget support, and related downsizing of the public sector, precipitated a substantial migration of 5,000 Cook Islanders (23 percent of its population) to New Zealand in a short period of time, according to a New Zealand official.

meet 98 percent of its educational operating expenses, according to a November 2000 ADB report on a proposed loan to the FSM.[16] Officials at Interior said the Compact economic assistance was expected to pay for recurring expenses as well as program expenses and capital improvements. To address their concerns, Australia and New Zealand adopted a joint policy in 1992 to define acceptable and unacceptable uses of assistance for recurring expenses. In addition, USAID has a policy on recurrent cost problems, which calls for funding of recurrent costs under narrow conditions, such as having a carefully phased plan for shifting the cost burden to the recipient government.

Donors Are Adopting Strategies to Improve Effectiveness in Light of Long-term Aid Dependence and Trade-offs

The major donors are exploring or have adopted assistance strategies designed to improve aid effectiveness while reacting to the context of providing aid in the Pacific region—long-term aid dependence; trade-offs among multiple motivations for assistance; and trade-offs to balance cost, effectiveness, and accountability.

Strategies That Promote Good Governance

Australia, Japan, New Zealand, the United Kingdom, and the ADB have adopted strategies that promote the development of good governance policies in the recipient countries. This emphasis follows the widely accepted principle that aid is more effective in countries with good policy environments in place.[17] According to the Australian Agency for International Development, "good governance" means competent management of a country's resources and affairs in a manner that is open, transparent, accountable, equitable, and responsive to people's needs. Australia, for example, supports efforts to develop a rule of law. The New Zealand Ministry of Foreign Affairs and Trade believes that good governance is critical to dealing with such issues as drug trafficking, money laundering, Internet scams, and migratory diseases. The ADB, as one example of a donor that embraces this principle, shifted its strategy in 1995 to focus on economic policy and good governance issues. Between

[16]*Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Federated States of Micronesia for the Basic Social Services Project* (Manila, Philippines: Asian Development Bank, Nov. 2000).

[17]According to a World Bank study, *Assessing Aid—What Works, What Doesn't, and Why* (Washington, D.C.: World Bank, Nov. 1998), where there is sound country management, an additional 1 percent of gross domestic product in aid translates into a 1-percent decline in poverty and a similar decline in infant mortality. In the absence of good policies, aid had no positive effect on growth.

1995 and 1998, the ADB supported reform efforts in seven Pacific Island nations to improve policy environments, including fiscal reform programs in the FSM and the RMI, which led to reductions of 37 percent and 33 percent, respectively, in the size of their public sectors.

Strategies Tailored to Local Development Conditions and Needs

In 2000, the ADB adopted a new development strategy for the Pacific that takes a subregional approach, underscoring the differences between various Pacific Island nations. The ADB strategy separates the island nations into three categories that are based on the nations' resource profiles and their growth prospects. For example, the ADB lists the RMI and the FSM in different categories. The strategy for the RMI, which is an island atoll nation with severe development disadvantages emphasizes the use of trust funds to support sustainable financing of basic services and development of niche markets such as tourism. In contrast, the strategy for the FSM, which falls into the category of countries with a higher skill base, good growth prospects, and moderate resource potential, focuses on physical infrastructure and private sector development to promote economic growth.

According to the ADB's strategy, the implementation of its previous strategy in 1996 provided several lessons, including the need (1) for the Pacific Island nations to have stronger ownership of policy and reform programs and (2) to design development strategies that take account of local cultures and capacities.

Strategies That Incorporate Flexibility

Flexible strategies are allowing donors to use their assistance as incentives and disincentives. Australia recently created two development incentives within its strategies that can provide funds for activities outside the annual program plan. One incentive, a fund for Papua New Guinea, has two components: one, a policy component to encourage and reward the effective implementation of the government development policy, and, two, a program component to fund organizations that have track records of good program management. Another incentive, the Policy and Management Reform initiative in the Pacific, allocates funds competitively to countries on the basis of demonstrated commitment to reform. Australia provided assistance from the fund to Vanuatu, for example, to reinforce a new government's commitment to economic and public sector reform.

Flexibility in their strategies also enabled Australia and New Zealand to stop delivering assistance under undesirable circumstances. New Zealand, for example, suspended funding to the governments of Fiji, in response to a coup, and to the Solomon Islands, in response to civil unrest, while

maintaining the assistance to community organizations so that aid for basic human services could continue. Australia also suspended some of its funding to Fiji due to political unrest and, in the Solomon Islands, refocused its aid on peace, security, and basic needs when ethnic conflict disrupted the country and the delivery of the aid program in mid-2000. According to New Zealand officials, flexibility is a key in selecting an assistance strategy, because it allows donors the ability to adjust programs over time as priorities and development needs change. Australia's *Pacific Islands Development Strategy, 1999-2001* recommends that the donor avoid locking in commitments to rigidly designed projects to minimize the risk that the donor is not able to adjust the aid when priorities or other critical circumstances change.

Strategies Are Based on Donor Coordination

All of the major donors have highlighted their donor coordination efforts to improve the efficiency of delivering assistance and reduce the burden of multiple donor requirements on recipients. Australia and New Zealand, for example, are studying options for harmonizing their programs to streamline their own operations and to increase their overall effectiveness. They believe that harmonization could also minimize the impact of multiple donor requirements on the recipient government. According to a World Bank official, the different reporting and other requirements of up to 18 different organizations providing assistance to the health sector in the Solomon Islands are stretching the capacity of the Solomon Islands government. In addition, the ADB hosts regular donor consultation meetings to discuss the development assistance needs of individual recipients and to coordinate assistance to avoid duplication. Finally, Australian officials said donor coordination is most effective if the recipient countries lead the coordination effort. Where the countries lack the capacity to lead the coordination effort, the donors should assist them to strengthen the coordination functions. However, according to the Australian officials, some recipient countries play donors off of each other to increase the amount of assistance, and, thus, they have limited interest in closer donor coordination.

Trust Funds to Address Long-term Dependence

Six donors have set up or contributed to trust funds in the Pacific as a means of providing recipients with a sustainable source of revenue and, in one case, ending annual bilateral assistance.[18] The ADB's Millennium Strategy for the Pacific suggests that trust funds may be an appropriate assistance strategy for bilateral donors to provide to atoll nations, such as

[18]Australia, Japan, New Zealand, the United Kingdom, the United States, and the ADB.

Kiribati and the RMI, which have few natural resources and little potential for economic growth. A 1999 report prepared for the ADB noted that two trust funds in the Pacific, the Tuvalu Trust Fund and the Kiribati Revenue Equalisation Reserve Fund, have been successful but that several others were less successful due, in part, to fraud, poor management, unclear objectives, and risky investments. The report stated that the Tuvalu and Kiribati funds were successful primarily because they were designed to protect the investment capital from misuse. As a result of its contribution to the Tuvalu Trust Fund in 1987, the United Kingdom ceased its annual budget support to Tuvalu, because the trust fund provided the means to balance the budget. According to the consultant who prepared the report to the ADB, other funds, such as the Nauru Phosphate Royalties Trust, have been less successful, because the funds were not designed to ensure good management and to protect the fund's capital from being spent.[19] The consultant believes that a lesson learned from his review of trust funds is that a well-designed trust fund can help recipient countries reduce their aid dependency levels and become more self-reliant. (See app. IV for more discussion about trust funds.)

Sectorwide Approaches to Balance Administrative Costs, Effectiveness, and Accountability

In 1999, Australia began testing a new approach for delivering assistance, called a "sectorwide approach,"[20] after it found that the cost of managing the project assistance in Papua New Guinea was too high. To reduce its administrative costs while trying to maintain aid effectiveness, Australia adopted the sectorwide approach to deliver assistance to the health sector in Papua New Guinea. Through this pilot project, Australia began moving from a portfolio of 16 individual health projects to cofinancing (with other donors) of sectorwide projects and programs identified in Papua New Guinea's national health plan. In exchange for giving up control over the projects, Australia gained a voice in developing the national strategy and allocating resources for health projects. The approach also encouraged Papua New Guinea to become a major stakeholder in the development process, following a generally believed principle that aid is more effective when developing countries determine their own needs and strategies for meeting them. The Australian pilot project is small scale and has not yet

[19]We did not look at the Nauru Phosphate Royalties Trust fund to make an independent determination on the success or failure of the investment.

[20]There is extensive development literature on the purpose and use of sectorwide approaches, known as SWAps in the development community. According to a USAID position paper, there were about 80 sector programs being prepared or implemented throughout the world as of June 2000, mostly in highly aid-dependent countries. See appendix V for a discussion of sectorwide approaches.

been evaluated. According to an Australian official, the sectorwide approach will cover about 25 percent of all of Australia's assistance to Papua New Guinea by 2002. Australia is also considering sector-based approaches for education in Kiribati and, eventually, for health care in the Solomon Islands.

Donors' Experiences Can Help Guide U.S. Approaches to Future Assistance

Our review of the lessons learned from the major donors' experiences in the Pacific could provide some guidance to the United States as it negotiates further economic assistance to the FSM and the RMI. These lessons deserve attention because the current U.S. assistance to the two countries and the proposed approach for future assistance through the Compact of Free Association often contrast with the other major donors' experiences, as discussed in the following points:

- Assistance Strategies May Involve Trade-offs in Expectations of Aid Effectiveness If the Main Motivation for Assistance Is Not Development.

  Donor strategies demonstrate that the effectiveness of the assistance in achieving the development objectives can depend on the principal motivation for providing the assistance. Often, donors have multiple motivations for providing assistance, such as historical links, which could have different standards for effectiveness and accountability. For example, the U.S. priority on maintaining friendly relations with the FSM and the RMI during the early years of the Compact, in order to protect strategic interests in the region, contributed to limited accountability requirements for the financial assistance and the degree of oversight.

- Assistance Strategies Involve Trade-offs Between Cost, Effectiveness, and Accountability.

  In general, choosing a strategy involves balancing donor interests in aid effectiveness and accountability with the higher administrative costs of donor involvement. When donors try to control their assistance to ensure effectiveness and accountability, their costs of administering the assistance increase. In the current Compact, the United States chose a low administrative cost strategy of providing relatively unrestricted cash transfers, which led to problems with the effectiveness of and accountability for the assistance. The proposal for new Compact assistance, according to a report prepared by an official in State's Office of

Compact Negotiations,[21] would provide financial assistance, in part, through six sectoral grants—health, education, infrastructure and maintenance, private sector development, capacity building, and the environment—each of which would have its own planning, monitoring, and reporting requirements. State and Interior officials have said that the United States will need significantly more staff to administer the proposed sectorwide grants to the FSM and the RMI than they currently have.

- Effective Assistance Depends on a Good Policy Environment in the Recipient Country.

  A common theme running through the major donors' assistance programs is the emphasis on good governance as a necessary condition for effective and sustainable development. As the ADB noted, "[I]t is important that the Bank first assist [the countries] to get their economic policy and governance environments right, thus ensuring that follow-up sector and project investments achieve due returns."[22] The United States also embraced this emphasis by supporting ADB technical assistance and reform programs for the FSM and the RMI, such as the Economic Management and Policy Advisory Team in the FSM. The Compact negotiator told the Congress that his approach for further assistance would include providing targeted grants for good governance and capacity building.

- Strategies Tailored to Specific Island Conditions May Be More Effective by Inviting Greater Recipient Ownership of the Program.

  Assistance strategies designed to reflect the diversity of the Pacific Islands may offer more potential to achieve economic growth than strategies that are not adapted to the recipient's needs and ability to participate in the development process. The ADB's new subregional approach to assistance, on the basis of differences in resources and growth potential, highlights the need for accommodating the different needs of the Pacific Island nations and suggests different strategies for the FSM and the RMI. By addressing local needs and accounting for local cultures, the assistance

[21]John Fairlamb, *Compact of Free Association Negotiations: Fulfilling the Promise*, a paper presented to the Island State Security Conference, Asia-Pacific Center for Security Studies (Honolulu, Hawaii: June 2001).

[22]*Reforms in the Pacific: An Assessment of the Asian Development Bank's Assistance for Reform Programs in the Pacific* (Manila, Philippines: Asian Development Bank, 1999).

strategies are more likely to ensure the political commitment of the recipient and are more likely to achieve outcomes. The ADB's approach contrasts with the current structure of Compact assistance for the FSM and the RMI, which generally applies the same objectives and strategies for the two countries.

- Flexible Strategies Are Important to Adapt Assistance to Changing Circumstances and Needs.

  Flexibility in assistance strategies is enabling the donors to respond to changing conditions in the Pacific. Flexibility not only allows donors to curtail assistance if the funds are not used effectively or properly, but it also permits donors to (1) adjust strategies to meet changing needs, such as transferring resources from one sector to another, and (2) provide rewards or incentives for good performance. The United States' assistance to the FSM and the RMI through the first 15 years of the Compact was distributed according to a negotiated formula that did not allow changes in the distribution of the funds. Moreover, Interior officials believed that the provision of assistance with the "full faith and credit" of the United States, combined with a lack of controls typically available with domestic grant assistance, severely limited the ability to change funding levels, even in cases of misuse of funds.

- Well-designed Trust Funds Can Provide a Sustainable Source of Assistance and Reduce Long-term Aid Dependence.

  Successful trust funds in the Pacific can be designed to maintain and protect the fund value through prudent investment and management. Independent economic advisers, as required in the Tuvalu Trust Fund agreement, can also provide guidance to the government on the most effective use of fund proceeds. If the funds produce sufficient annual revenue to meet recipient budget needs and the revenues are used wisely, as has been the case with the Tuvalu Trust Fund, donors may have opportunities to reduce their annual assistance levels. The Compact negotiator has discussed similar trust funds for the FSM and the RMI in his approach for further assistance. According to FSM and RMI officials, the two countries have adopted their own trust fund agreements and anticipate using the agreements to invest the funds from future Compact assistance.

- Sectorwide Approaches Depend on Recipient Governments' Commitment and Ability.

Although Australia's sectorwide approach has only been tested on a small scale in the Pacific and has not yet been evaluated, the extensive literature on sectorwide approaches in Africa and other locations suggests that the approaches are effective only under certain conditions. These include operating in sectors where there is an agreement among donors and recipients regarding the need for a government role in the financing, planning, and delivery of services. Moreover, a review of sectorwide approaches around the world[23] found that such approaches are more effective when they correspond to the budget responsibility of a single sector, such as education and health, rather than sector programs for crosscutting themes, such as the environment. The Compact negotiator said that the approach for providing further assistance includes financial assistance in the form of sector grants to the FSM and the RMI in place of the cash transfers of the current Compact. In addition, three of the six sectors identified in the negotiator's proposal—private sector development, the environment, and capacity building and good governance—are crosscutting sectors.

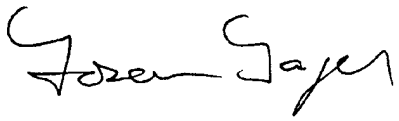
Agency Comments

We received comments from the Republic of the Marshall Islands and the Federated States of Micronesia. These governments generally sought greater discussion regarding the nature of the Compact relationship and the recognition of the unique nature of their countries. Their comments and our responses can be found in appendixes VI and VII.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this report. At that time, we will send copies of this report to interested congressional committees and to the Honorable Gale A. Norton, the Secretary of the Interior; the Honorable Colin L. Powell, the Secretary of State; His Excellency Leo A. Falcam, President of the Federated States of Micronesia; and His Excellency Kessai Note, President of the Republic of the Marshall Islands. We will also make copies available to others upon request.

[23] *New Approaches to Development Co-operation: What can we learn from experience with implementing Sector Wide Approaches?*, Working Paper 140 (London, England: Overseas Development Institute, Centre for Aid and Public Expenditure, Oct. 2000).

If you or your staff have any questions about this report, please call me at (202) 512-4128. An additional GAO contact and staff acknowledgments are listed in appendix VIII.



Loren Yager
Director, International Affairs and Trade

Appendix I: Objectives, Scope, and Methodology

The Chairman of the House Committee on Resources; the Ranking Minority Member of the House Committee on International Relations; the Chairman of the Subcommittee on East Asia and the Pacific, House Committee on International Relations; and the Honorable Doug Bereuter, House of Representatives, asked us to assist the Congress in its consideration of future economic assistance for the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) through the Compact of Free Association. Specifically, our objectives were to (1) identify the major donors of development assistance to the Pacific Island nations and their objectives, (2) discuss the donors' development assistance strategies and the factors or experiences that influence their choice of strategies, and (3) report lessons from the other donors' assistance strategies that could be useful for U.S. consideration.

Major Donors and Their Objectives

To identify the major donors in the Pacific Islands, we obtained and reviewed the annual development assistance statistics from 1987 through 1999 as reported by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). The committee's database allowed us to identify the official development assistance provided by members of OECD's Development Assistance Committee and multilateral donors to each Pacific Island nation. We relied on the committee's conversion of official development assistance into 1998 U.S. dollars. Our analysis of the committee's data found several inconsistencies, such as no reported development assistance to the FSM and the RMI before 1991. To resolve the problems that we found in the committee's data, we relied on our analysis of the annual financial audits for the FSM, the RMI, and Palau to determine the U.S. assistance levels to those countries. From our analysis of U.S. assistance to the FSM and the RMI, we know that the official development assistance excludes assistance such as educational Pell Grants given directly to students and U.S. Department of Agriculture housing loans. We included official development assistance provided to territories in the Pacific, when reported by the committee, but we excluded the portion of the assistance that the territories received from their national governments because it often is a transfer of domestic funds. For example, we did not include the amount that New Zealand gave to Tokelau because Tokelau is a territory of New Zealand; however, we did include the amount of assistance that Australia gave to Tokelau. The committee's database did not report official development assistance to some territories, such as American Samoa. Finally, we did not include development assistance data from other known donors, such as China and Taiwan. The committee's database does not report their assistance because the countries are not members of OECD's

Development Assistance Committee. Despite our attempts to collect data from China and Taiwan, these countries were unwilling to provide the information. China and Taiwan may be significant donors; one news article, for example, mentioned that China gave more than $150 million in untied grant aid to Papua New Guinea in 2000, which was nearly the same as Australia's annual assistance of $167 million.[24]

To identify the donor objectives, we reviewed recent development planning documents and interviewed officials from the Australian Agency for International Development; the Japan Ministry of Foreign Affairs, Economic Cooperation Bureau and European and Oceanian Affairs Bureau, and the Japan International Cooperation Agency; the New Zealand Ministry of Foreign Affairs and Trade, Official Development Assistance agency; the United Kingdom Department for International Development; the U.S. Agency for International Development (USAID); the U.S. Department of the Interior, Office of Insular Affairs; and at major multilateral donor agencies (the World Bank, the Asian Development Bank (ADB), the European Union (EU), and the United Nations Development Program).

To collect information on the recipient countries in the Pacific, such as population, gross domestic product, and geographic characteristics, we relied on data from the World Bank, the United Nations Development Program, the Secretariat of the Pacific Community, the Bank of Hawaii, and the U.S. Central Intelligence Agency's *World Factbook 2000*. We found that these data were often missing or were based on estimates. Through conversations with donors, we found that the lack of reliable statistics is widely accepted. To verify the integrity of the data, we (1) checked the reliability of data sources with multilateral agencies, such as the ADB; (2) cross-checked the information among various sources reporting Pacific Island data, such as comparing gross domestic product figures among the World Bank, the United Nations Development Program, and the Bank of Hawaii; and (3) used our best judgment.

Donor Strategies and Experiences

To identify the major donors' assistance strategies, we relied on information in donor documents and interviews with donor officials. To identify and explain the major donors' experiences in their choice of

[24]"Pacific Region Enters a New Era of Shifting Alliances," *The Sidney Morning Herald* (May 24, 2001).

strategies, we relied on the donor documents and our meetings with officials at the bilateral and multilateral donors. From this review of documents and the interviews, we identified specific assistance strategies, the reasons for choosing specific strategies, and examples of the effectiveness of the strategies. Relying on State's June 2000 testimony on its approach to negotiations with the FSM and the RMI, we narrowed the range of experiences identified in interviews and documents in selecting the experiences for discussion in this report. For our analysis of donor experiences with sectorwide approaches, trust funds, and good governance, we also relied on general reports and literature on development assistance to support the donor information.

Lessons Learned From Donors' Experiences

To report the lessons learned from the donors' experiences, we identified common themes that were potentially relevant to economic assistance to the FSM and the RMI. From this analysis, we developed some observations in the form of lessons learned from the donors' experiences. We also obtained information from USAID officials and documents about that agency's experiences in providing development assistance and in ending its Pacific program. Finally, we collected documents from and met with officials from the State's Office of Compact Negotiations and Interior's Office of Insular Affairs to identify issues related to the negotiations of future economic assistance to the FSM and the RMI.

We conducted our work from August 2000 through May 2001 in accordance with generally accepted government auditing standards.

Appendix II: Major Donors of Development Assistance to the Pacific Region

From 1987 through 1999, more than 22 countries and 13 multilateral organizations provided almost $12 billion (in 1998 U.S. dollars) in development assistance to the Pacific region. The amount of assistance ranged from a single donation of $10,000 by Spain to total donations by Australia of more than $3.8 billion. Major bilateral donors, such as Australia ($3.8 billion), the United States ($3.1 billion), Japan ($1.6 billion), New Zealand ($685 million), and the United Kingdom ($394 million), accounted for nearly 81 percent of the total development assistance to the region. The U.S. share was almost 26 percent of the total. Donations from the EU ($900 million) and the ADB ($506 million) constituted more than 80 percent of the aid from multilateral organizations and close to 12 percent of overall assistance. Together, these seven major bilateral and multilateral donors were responsible for almost 93 percent of the development assistance to the region. Other bilateral and multilateral donors contributed about 7 percent of the assistance.

Table 1 provides a side-by-side comparison of these five major bilateral donors, their development agencies and stated development objectives, and a list of the countries receiving more than 10 percent of the donor's aid to the region. Table 2 provides similar comparative information for the two major multilateral donors.

Table 1: Cumulative Assistance, Objectives, and Primary Recipients of Development Assistance From Major Bilateral Donors to the Pacific Region, 1987-99

(Amounts in 1998 U.S. dollars)

Major donor	Cumulative development assistance	Development organization and objectives	Primary recipient (more than 10% of donor's aid)
Australia	$3.84 billion	The Australian Agency for International Development, an administratively autonomous agency of the Department of Foreign Affairs and Trade, administers the overseas aid program. Objectives: • Reduce poverty and achieve sustainable development. • Focus on helping countries to achieve the maximum possible degree of self-reliance by contributing to better governance, stronger growth, greater capacity, better service delivery, and environmental integrity.	Papua New Guinea: $2.87 billion, 74.8% of total
United States	$3.06 billion	The Department of the Interior administers bilateral development assistance to the Freely Associated States (FSM, RMI, and Palau) through the Compact of Free Association. USAID, an agency of the Department of State, is the primary development agency of the United States. Objectives: • Assist the Freely Associated States in their efforts to advance economic development and self-sufficiency. (Department of the Interior) • Support the people of developing countries in their efforts to achieve enduring economic and social progress and to participate more fully in resolving the problems of their country. (USAID)	FSM: $1.63 billion, 53.3% of total RMI: $779 million, 25.4% of total Palau: $382 million, 12.5% of total
Japan	$1.59 billion	The Ministry of Foreign Affairs is responsible for planning and coordinating Japan's development assistance. The Japan International Cooperation Agency and the Japan Bank for International Cooperation are the implementing agencies. Objectives: • Support the self-help efforts of developing countries to achieve economic self-reliance. • Focus on supporting social and economic infrastructure development, economic structural reforms, human resource development for the private sector, environmental conservation, and regional cooperation.	Papua New Guinea: $560 million, 35.2% of total Fiji: $169 million, 10.7% of total Solomon Islands: $163 million, 10.2% of total
New Zealand	$685 million	The Development Cooperation Division of the Ministry of Foreign Affairs and Trade manages the New Zealand Official Development Assistance Program. Objective: • Achieve lasting improvements in the living conditions of people in developing countries, especially the poor, by	Oceania unallocated: $160 million, 23.4% of total Cook Islands: $95 million, 13.9% of total Samoa: $70 million, 10.2% of total Niue: $69 million, 10.1% of total

(Amounts in 1998 U.S. dollars)

Major donor	Cumulative development assistance	Development organization and objectives	Primary recipient (more than 10% of donor's aid)
		supporting good governance, civil society, social development, gender equity, environmental protection, and a sound business environment that encourages private enterprise, and policy and regulatory reforms.	
United Kingdom	$394 million	The Department for International Development is responsible for the British aid program. Objectives: • Eliminate poverty through sustainable development. • Focus on two key sectors—education, and rights and good governance.	Oceania unallocated: $94 million, 23.7% of total Solomon Islands: $81 million, 20.5% of total Vanuatu: $80 million, 20.4% of total Papua New Guinea: $53 million, 13.5% of total

Sources: Australian Agency for International Development, Japan Ministry of Foreign Affairs, New Zealand Ministry of Foreign Affairs and Trade, the United Kingdom Department for International Development, and USAID documents and interviews; Compact of Free Association; and GAO analysis of OECD data and annual financial audits of the FSM, the RMI, and Palau.

Table 2: Cumulative Assistance, Objectives, and Primary Recipients of Development Assistance From Major Multilateral Donors to the Pacific Region, 1987-99

(Amounts in 1998 U.S. dollars)

Major donor	Cumulative development assistance	Development organization and objectives	Primary recipient (more than 10% of donor's aid)
European Union	$900 million	The EU assistance structure is comprised of three organizations. The Directorates-General of External Relations and Development are the primary policymaking departments, while the Europe Aid Co-operation Office is responsible for implementing and administering aid programs and projects. Objective: • Poverty reduction supported through an emphasis on economic development; social and human development; regional cooperation and integration; and the crosscutting themes of gender equity, environmental sustainability, and institutional development and capacity building.	Papua New Guinea: $477 million, 52.9% of total Solomon Islands: $112 million, 12.5% of total
Asian Development Bank	$506 million[a]	The ADB's Office of Pacific Operations administers assistance in the 12 developing member countries. Objective: • Poverty reduction supported through economic, governance, and public sector reform; private sector development; a more active role for women in social, political, and economic spheres; and sustainable environment management.	Papua New Guinea: $225 million, 44.4% of total Samoa: $53 million, 10.4% of total

[a]This figure does not include most loans provided by the ADB to recipient countries.

Sources: ADB and EU documents and interviews, and GAO analysis of OECD data.

Appendix III: Recipients of Development Assistance in the Pacific Region

Between 1987 and 1999, donors provided about $11.9 billion in development assistance to 14 sovereign nations and 5 territories in the Pacific region, according to data reported by the OECD's Development Assistance Committee. The recipients ranged from Papua New Guinea, with almost 70 percent of the region's 6.4 million residents, to Niue, with 1,500 residents. This appendix presents information on the characteristics of the sovereign island nations, data on their development assistance, and information on how they compare with other islands in the region.

Recipient Characteristics and Data

The Pacific Island countries vary substantially in their size and population and the composition of their geography. Fiji, with a land area of 7,055 square miles and a population of 785,000, is very different from the remote and small, low-lying atolls of Kiribati, which encompasses only 266 square miles and has a population of 85,100. These islands also span a wide range in terms of their human development. The United Nations Development Program created the Human Development Index to measure development progress in three dimensions—life expectancy, educational attainment, and per capita gross domestic product (GDP)—and to show where each country stands in relation to the scales, which are expressed as a value between 0 and 1, with 1 being the highest score. The FSM and the RMI are in the bottom half of a list of Pacific Island nations, according to their index scores in 1998, despite their high GDP per capita.

Table 3 displays basic information on development assistance recipients' land area, geographic characteristics, population, political status, per capita GDP, and Human Development Index. While Palau ranks the highest (0.861) and Papua New Guinea the lowest (0.371) in the Human Development Index, both the FSM and the RMI fall closer to the middle of the index, reporting 0.569 and 0.563, respectively.

Table 3: Information on Pacific Islands That Received Development Assistance in 1998

(Amounts in 1998 U.S. dollars)

Country	Land area (square miles)	Geographic characteristics	Population	Political status	Per capita GDP	Human Development Index
Cook Islands	92	15 widely dispersed islands, volcanic peaks, and atolls.	19,200	Independent, in free association with New Zealand	$2,651[b]	0.822
Fiji	7,055	320 islands. Major islands are mountainous and forested.	785,700	Independent	2,008	0.667
FSM	270	607 islands and atolls.	114,100[a]	Independent, in free association with the United States	1,864	0.569
Kiribati	266	33 islands, almost entirely low-lying, scattered atolls.	85,100	Independent	530	0.515
Nauru	8	Single island made up of nearly exhausted, phosphate-bearing rock.	11,500	Independent	7,017[b]	0.663
Niue	101	Coral island.	1,500	Independent, in free association with New Zealand	4,733[b]	0.774
Palau	170	343 islands, encircled by a 100 mile reef.	18,500	Independent, in free association with the United States	6,989	0.861
Papua New Guinea	179,490	Largest Pacific island-state land mass.	4,412,400	Independent	843	0.314
RMI	70	34 coral islands, 870 reefs, and average elevation of 7 feet.	50,840[c]	Independent, in free association with the United States	2,008[b]	0.563
Samoa	1,158	4 of 9 islands inhabited.	174,800	Independent	1,004	0.590
Solomon Islands	11,197	850-mile-long double island chain. Six mountainous main islands.	417,800	Independent	720	0.371
Tonga	386	Main islands volcanic, some 150 coral atolls, 36 inhabited.	98,000	Independent	1,763	0.647
Tuvalu	10	5 atolls, 4 coral islands.	11,000	Independent	345[b]	0.583
Vanuatu	4,707	80 scattered islands, several active volcanoes.	182,500	Independent	1,319	0.425

Note: The Human Development Index measures development progress in three dimensions—life expectancy, educational attainment, and per capita gross domestic product—and shows where each country stands in relation to the scales, which are expressed as a value between 0 and 1, with 1 being the highest score.

[a]The FSM population, according to the 2000 Census, is now about 107,000.

[b]The Bank of Hawaii, the source of these data, was unable to identify the specific year for the figures.

[c]Secretariat of the Pacific Community, 1999.

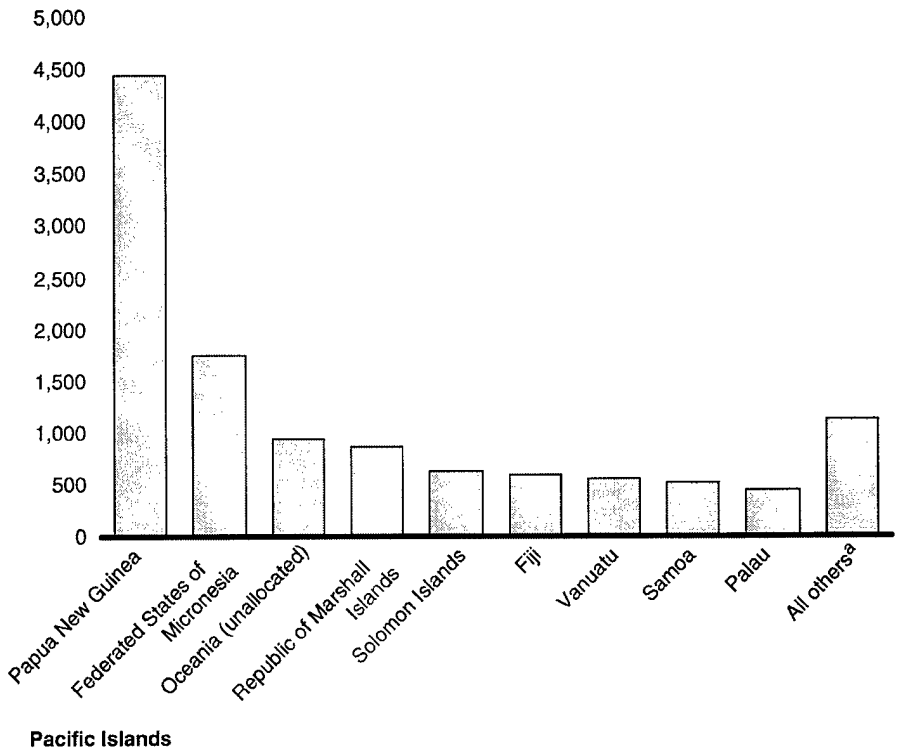
Sources: Bank of Hawaii, New Zealand Ministry of Foreign Affairs and Trade, Secretariat of the Pacific Community, Central Intelligence Agency's *World Factbook 2000*, the World Bank, and the United Nations Development Program.

Development Assistance and Its Role in the Recipients' Economy

This section describes development assistance over time, identifies each recipient's major donors and how much assistance is provided, compares differences in the amount of assistance per capita among recipients, and analyzes the role of development assistance in the economy by measuring assistance as a percentage of GDP.

Between 1987 and 1999, the FSM and the RMI each received substantially higher amounts of assistance—$1.8 billion and $873 million, respectively—than other recipients, except for Papua New Guinea, which received $4.4 billion in assistance. Figure 3 shows the total amount of assistance received by the major Pacific Island recipients for 1987 through 1999.

Figure 3: Recipients of Development Assistance to the Pacific Region, 1987-99



[a] "All others" includes the Commonwealth of the Northern Marianas, the Cook Islands, French Polynesia, Kiribati, Nauru, New Caledonia, Niue, Tokelau, Tonga, Tuvalu, and Wallis and Futuna.

Sources: GAO analysis of OECD data and annual financial audits of the FSM, the RMI, and Palau.

The assistance per capita varied widely for the 14 Pacific Island nations. Table 4 shows that Niue received more than $2,700 in assistance per capita in 1998, while Fiji received $46 in assistance per capita. The median assistance per capita was $680. The RMI and the FSM ranked third and fourth, respectively, among the recipients.

Table 4: Assistance per Capita and Total Development Assistance for Pacific Islands, 1998

(Amounts in 1998 U.S. dollars)

Recipient	Assistance per capita	Total assistance (millions)
Niue	$2,720	$4.1
Palau	2,168	40.1
RMI	1,438	73.1
FSM	1,010	115.3
Tuvalu	471	5.2
Cook Islands	420	8.1
Tonga	252	24.7
Vanuatu	223	40.6
Samoa	208	36.4
Kiribati	203	17.3
Nauru	183	2.1
Solomon Islands	102	42.6
Papua New Guinea	82	361.2
Fiji	46	36.5

Sources: GAO analysis of OECD data and annual financial audits of the FSM, the RMI, and Palau; and the Secretariat of the Pacific Community.

Seven of the recipient countries have received more than half of their assistance from a single donor. The RMI, the FSM, Nauru, and Palau, for example, have received at least 87 percent of their 1987 through 1999 assistance from a single donor. Table 5 lists the five largest donors, and their share of total assistance, for each recipient country for 1987 through 1999.

Table 5: Recipients of Development Assistance and Their Major Donors, 1987-99

(Amounts in 1998 U.S. dollars in millions)

Recipient	Major donor	Total aid	Percentage of total aid
Cook Islands	New Zealand	$94.92	61.8%
	ADB	23.4	15.2
	Australia	15.99	10.4
	Japan	4.4	2.9
	UNDP	4.36	2.8
	All other donors	10.42	6.8
Fiji	Australia	194.89	33.4
	Japan	169.32	29.0
	New Zealand	60.68	10.4
	UNTA	17.15	2.9
	France	30.6	5.2
	All other donors	111.34	19.1
FSM	United States	1,632.26	92.8
	Japan	81.91	4.7
	ADB	28.84	1.6
	Australia	6.07	0.3
	UNDP	3.48	0.2
	All other donors	6.64	0.4
Kiribati	Japan	90.33	38.2
	Australia	49.56	21.0
	United Kingdom	29.3	12.4
	New Zealand	23.69	10.0
	EU	22.56	9.5
	All other donors	20.81	8.8
Nauru	Australia	12.27	67.2
	Japan	5.48	30.0
	UNTA	0.17	0.9
	New Zealand	0.08	0.4
	Other UN agencies	0.06	0.3
	All other donors	0.19	0.1
Niue	New Zealand	69.02	88.2
	Australia	6	7.7
	UNDP	2.02	2.6
	Japan	0.59	0.8
	UNTA	0.49	0.6
	All other donors	0.14	0.2

(Amounts in 1998 U.S. dollars in millions)

Recipient	Major donor	Total aid	Percentage of total aid
Palau	United States	381.51	87.5
	Japan	49.55	11.4
	Canada	1.99	0.5
	Australia	1.19	0.3
	UNTA	0.39	0.1
	All other donors	1.56	0.3
Papua New Guinea	Australia	2872.92	64.6
	Japan	559.72	12.6
	EU	476.63	10.7
	ADB	224.74	5.1
	Germany	92.64	2.1
	All other donors	218.27	4.9
RMI	United States	779.27	89.2
	Japan	50.01	5.7
	ADB	36.36	4.2
	Australia	2.58	0.3
	UNDP	2.18	0.2
	All other donors	2.86	0.3
Solomon Islands	Japan	162.5	25.9
	EU	112.28	17.9
	Australia	111.6	17.8
	United Kingdom	80.7	12.9
	ADB	40	6.4
	All other donors	119.98	19.1
Tonga	Australia	92.35	27.3
	Japan	90.68	26.8
	New Zealand	50.29	14.9
	ADB	36.53	10.8
	EU	28.35	8.4
	All other donors	40.09	11.9
Tuvalu	United Kingdom	37.44	29.3
	Australia	28.72	22.5
	Japan	22.81	17.9
	New Zealand	22.68	17.8
	UNDP	4.63	3.6
	All other donors	11.45	9.0
Vanuatu	Australia	125.73	22.7
	France	111.5	20.2
	United Kingdom	80.29	14.5
	Japan	64.76	11.7
	EU	55.57	10.0
	All other donors	115.19	20.8

(Amounts in 1998 U.S. dollars in millions)

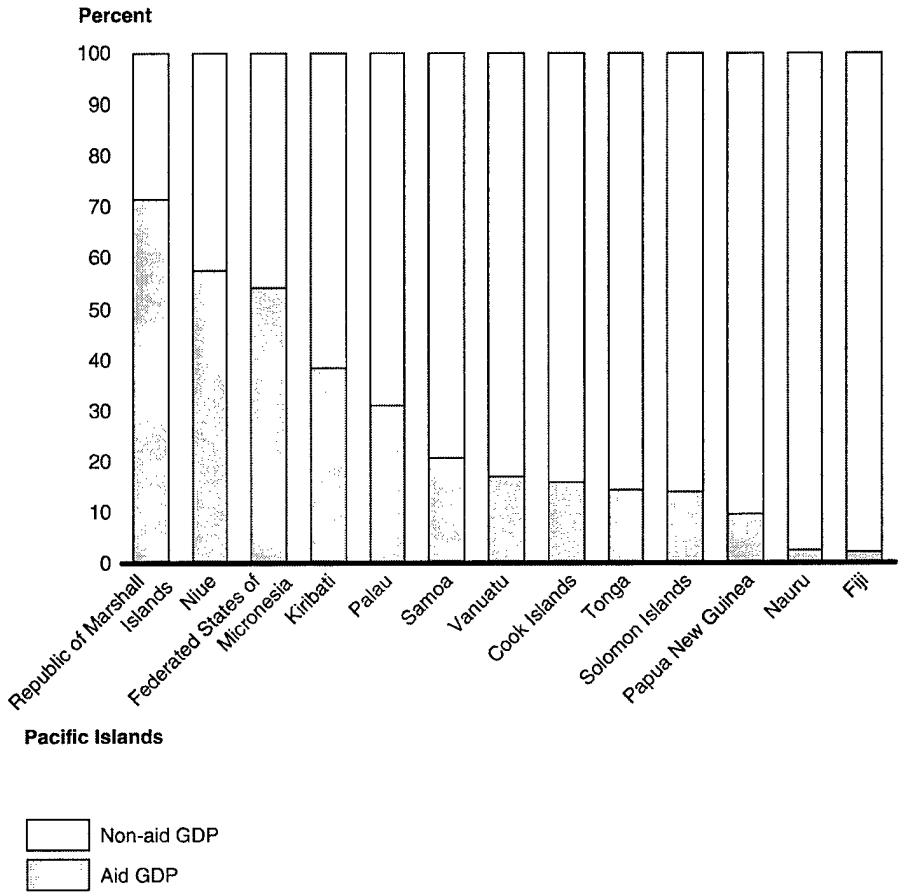
Recipient	Major donor	Total aid	Percentage of total aid
Samoa	Japan	135.51	26.6
	Australia	101.74	20.0
	New Zealand	69.59	13.7
	ADB	52.84	10.4
	EU	46.69	9.2
	All other donors	102.17	20.1

Legend: UNDP = United Nations Development Program
UNTA = United Nations Technical Assistance

Sources: GAO analysis of OECD data and annual financial audits of the FSM, the RMI, and Palau.

Finally, figure 4 provides information on the proportion of aid that makes up each country's GDP. In 6 of 13 countries, aid constitutes 20 percent or more of their GDP. For example, the FSM and the RMI rely heavily on development assistance—more than 50 percent of their GDP—to sustain their economies.

Figure 4: Proportion of Aid and Non-aid in 13 Pacific Islands' GDP, 1998



Note: We did not include Tuvalu in this figure because inconsistencies in the data did not provide reliable information.

Sources: GAO analysis of OECD data and annual financial audits of the FSM, the RMI, and Palau; the World Bank; and the Bank of Hawaii.

ADB Classification of Pacific Islands

Although there are great differences among the size, population, geographic characteristics, economic development, social indicators, and other features of Pacific Island recipients of development assistance, the ADB has classified the island nations according to their development conditions and recommended assistance strategies for each type of island classification.[25]

The ADB places its member countries into three categories on the basis of resource endowments, population, poverty level, social characteristics, international labor mobility, growth prospects, and strategies tailored for each classification. Atoll economies have little prospect for economic development, and there is special concern about the sustainability of financing of essential services. The ADB therefore recommends that island atolls (the RMI, Kiribati, Nauru, and Tuvalu) develop trust funds and continue to rely on aid for their economic sustainability. In contrast, the strategy for economically advanced countries (Fiji, Samoa, the FSM, Tonga, and the Cook Islands) is to focus on physical infrastructure and private sector development as well as tourism industry development. For Papua New Guinea, the Solomon Islands, and Vanuatu (the Melanesian nations), the group with the most potential for growth, the ADB priority is to expand access in rural areas, reduce high population growth rate, and build local government capacity. (See table 6 for the ADB's classification of the Pacific Islands in its Pacific Strategy.)

[25] *A Pacific Strategy for the New Millenium* (Manila, Philippines: Asian Development Bank, Sept. 2000).

Table 6: ADB Classification of Resource Endowments and Opportunities in the Pacific Islands

Category	Melanesian nations: Papua New Guinea, Vanuatu, Solomon Islands	Economically advanced nations: Fiji, Samoa, FSM, Tonga, Cook Islands	Island atoll nations: RMI, Nauru, Tuvalu, Kiribati
Natural resource endowments	Abundant	Moderately good	Small, isolated, weak resource base, high vulnerability to sea-level rise
Population	High growth, low density	Not discussed	High density
Poverty level	High	Low	Low
Social indicators and/or social services	Poor	Good	Not discussed
International labor mobility	Low	High	Not discussed
Growth prospects	Good	Modest	Little
Strategies	Expand access in rural areas to basic services and microfinance; reduce high population growth rate; build local government capacity.	Focus on private sector development and physical infrastructure to promote economic growth; further develop tourism industry.	Establish and expand trust funds to finance public expenditures; explore opportunities to develop marine resources, tourism supports, and skills development for labor export.

Source: ADB.

Appendix IV: Trust Funds in the Pacific

Several trust funds exist in the Pacific. Their objective is to provide a source of sustainable revenue from the proceeds from investment of the trust fund capital. According to a report prepared in 1999 for the ADB,[26] these funds have had mixed results. The Tuvalu Trust Fund, which was set up by aid donors to provide sustained revenue, is cited as a model for future trust funds because the fund agreement incorporates key design features. The report to the ADB, plus other reports by the United Nations[27] and USAID,[28] identify specific design characteristics that may lead to successful trust funds.

Trust Funds in the Pacific

Several trust funds are currently operating in the Pacific. Examples include the Tuvalu Trust Fund; the Kiribati Revenue Equalisation Reserve Fund; the Banaban Trust Fund; the Marshall Islands resettlement trust funds for Bikini Island, Enewetak, Utrik, and Rongelap; the Palau Trust Fund; and the Nauru Phosphate Royalties Trust. These funds were designed to serve a range of purposes, including the development of rural communities or outer islands, management of recurring government expenses, and assistance in achieving greater financial autonomy.

Six of the seven major donors have contributed to trust funds. For example, Australia, New Zealand, the United Kingdom, and Japan have donated funds to the Tuvalu Trust Fund. The United States contributed to the Palau Trust Fund. Finally, the ADB provided a loan for another trust fund in Tuvalu that was designed to assist outer island development.

Although the funds of Kiribati and Tuvalu are known for their success in maintaining fund value, both funds have received criticism because they have tended to reinvest their revenues into the funds instead of using them for development. In contrast to the investment success of the Kiribati and Tuvalu funds, the Banaban Trust Fund has encountered serious difficulties involving misappropriation and poor management of the fund's capital,

[26] *Review of Existing and Proposed Trust Funds,* prepared for the ADB (Wellington, New Zealand: Nimmo-Bell & Company, Mar. 31, 1999).

[27] "Trust Fund Formulation: A Strategy for Sustainable Development," in *Integrated Macroeconomic Development Planning and Management for Sustainable Development: Guidelines for Island Developing Countries* (New York: United Nations, Department for Development Support and Management Services, 1993).

[28] *Endowments as a Tool for Sustainable Development,* USAID Working Paper #221 (Washington, D.C.: USAID, Center for Development Information and Evaluation, July 1996).

due to the failure of the fund structure to separate fund managers and fund users and to protect the fund capital. Similarly, the Nauru Phosphate Royalty Trust has lost most of its value due to poor advice from its legal and economic advisers. In addition, Nauru has borrowed against future earnings of the Trust. Finally, the Bikini Island Resettlement Trust Fund, although successful in providing a stream of revenue, has experienced difficulty in finding an equitable distribution mechanism for revenue to beneficiaries because clear guidelines were not established in the fund agreement.

Example of Successful Trust Fund: Tuvalu Trust Fund

The Tuvalu Trust Fund was created by an international agreement between Tuvalu, Australia, New Zealand, and the United Kingdom in 1987. The fund was set up to enable the small island nation to help finance chronic budget deficits, underpin economic development, and achieve greater financial autonomy. As a result of the agreement to create the fund, annual British aid for recurring budget expenses ended. Initial contributions to the fund in 1987 amounted to Austalian $27.1 million.[29] The initial donors were Tuvalu, Australia, New Zealand, and the United Kingdom, with later contributions from Japan and South Korea. The fund capital had $66 million, as of December 2000, and Tuvalu has set an informal target of $100 million before it will stop reinvesting in the fund.

The fund management structure includes (1) a Board of Directors, with each member having been appointed by an original donor; (2) professional fund management; (3) external auditors; and (4) an advisory committee. According to one of its members, the advisory committee regularly evaluates and monitors the fund and provides advisory reports to the government of Tuvalu and the Board of Directors. Each of the original donors has a member on the committee, while Tuvalu currently has two members. Although the donors nominate the advisory committee members, the committee acts independently. The member from New Zealand, for example, does not consult with New Zealand on economic decisions.

Another key element of the fund is the separation of fund capital from fund proceeds available for distribution. The fund capital is held in an "A"

[29]The fund is maintained in Australian dollars. Due to subsequent contributions by Tuvalu through reinvestment, Tuvalu's contributions of Australian $15.5 million, as of March 1999, made it the largest contributor to the fund.

account and invested primarily in Australia. The objectives of the A account are to maintain the real value of the fund and to provide a regular stream of income to the government of Tuvalu. Income earned from the investments is calculated annually. Generally, part of the income is automatically reinvested to maintain the real value of the fund, while remaining income is placed in a separate account, the "B" account, to hold it for distribution to the government of Tuvalu. According to a report on the 10th anniversary of the trust fund,[30] the B account has become an important tool for the government to use in managing its cash flow. The government limits budget growth to the amount of money the fund can deliver.

According to an advisory committee member, the trust fund agreement does not allow the donors to intervene in determining how Tuvalu uses the fund proceeds. A U.N. review of the fund noted that this arrangement provides the Tuvalu government with a considerable degree of financial independence, which was not possible under a system of direct bilateral assistance. Bad decisions by the Tuvalu government would affect only the B account, not the fund capital.

Key Design Features for Trust Funds

According to the reports on trust funds, these funds can be effective instruments for providing development assistance if they are properly designed and managed. The Nimmo-Bell & Company 1999 report to the ADB[31] identified several issues that trust funds must address:

- The purpose of the fund must be clear and specific, along with containing clear and measurable goals and objectives.
- There should be a legal structure that permits the establishment of the fund; tax laws allowing the fund to be tax exempt, within the country and internationally; and a provision for donations from public and private contributors.
- There must be a sound, transparent, and accountable governance structure.

[30] *Tuvalu Trust Fund, 10th Anniversary Profile, 1987-1997*, produced by Brian Bell, Tuvalu Trust Fund Advisory Committee, with assistance from Garry Wiseman and Tony Hughes (Wellington, New Zealand: no date)

[31] *Review of Existing and Proposed Trust Funds.*

- Mechanisms must be provided to ensure involvement of a broad set of stakeholders, including the beneficiaries, central and local government, and donors during the design process.
- Adequate protection mechanisms must be built into the structure to safeguard the capital of the fund and ensure a fair distribution of benefits.
- Strong linkages should exist between the fund and national strategies and action plans.
- Baseline information should be collected at the initiation of the trust fund so that the performance can be measured against the criteria.
- Money managers should be selected on a competitive basis.
- The sophistication of investment management should reflect the size of the fund in order to keep administrative and transaction costs to an appropriate level.
- Technical assistance should be provided during the establishment phase and the first few years of operation to assist fund managers in implementing the intent of the fund and to monitor its performance.

According to a U.N. report,[32] trust funds are most appropriate for addressing development problems that require a continuous income stream over a long-term period. A key advantage of a trust fund for donors is its cost-effectiveness in reducing the administrative costs associated with individual projects or aid cycles. The advantages of a trust fund for recipients are the abilities to (1) improve the coordination, consistency, and sustainability of overall development efforts; (2) reduce administrative efforts linked with obtaining assistance and preparing reports on the use of donor resources; and (3) coordinate disbursements of assistance with institutional capacity to manage the assistance.

Finally, according to a USAID working paper on endowment funds (trust funds), several lessons are available from USAID's involvement in funding more than 35 endowment funds.[33] These lessons include the need for adequate financing to establish the fund, the strategic use of matching funds to leverage the U.S. contribution, and the importance of fund independence from government or secular interests. The principal conclusions from the review of USAID endowment funds were that (1) under the appropriate conditions, such funds can be a viable option for providing long-term, sustainable development; (2) using funds can be an important strategy for increasing the capabilities of development partners;

[32]"Trust Fund Formulation: A Strategy for Sustainable Development."

[33]*Endowments as a Tool for Sustainable Development.*

(3) strong institutions that are well managed and have successful track records are an essential prerequisite to funding; and (4) by their nature, funds involve less USAID monitoring and oversight than other types of activities because of built-in safeguards. These safeguards include (1) USAID involvement in the design of the fund agreement, (2) USAID approval of the initial Board of Directors and possibly appointment of a board member, (3) annual audits and performance reports, and (4) a requirement that all funds be invested in financial instruments offered in the United States through a U.S.-based financial intermediary. The report concluded that using well-designed funds that are consistent with USAID and host country objectives are a "natural" for countries graduating from USAID assistance.

Appendix V: Sectorwide Approaches to Development Assistance

Sectorwide approaches emerged in the 1990s as a form of assistance designed to return ownership of the development process to the recipient government, according to a report by the Overseas Development Institute.[34] The approaches are a response to (1) recent work on aid effectiveness, which found that development assistance requires a supportive policy environment in the recipient country in order to achieve sustainable benefits, and (2) concern that a proliferation of stand-alone, donor-funded projects has led to a piecemeal and distorted pattern of development. In addition, donors believe that poor coordination has contributed to multiple donor agendas and reporting systems, which has complicated the development process for recipient countries.

Sectorwide approaches are expected to achieve greater coherence in the use of aid by allowing recipient governments to assume ownership for the planning and implementation of all activities within a specific sector. If the donor projects are not set within a coherent plan and budget, the result can be an effort that is expensive to manage and in which there is wasteful duplication, uneven coverage, inconsistent approaches, and poor sustainability of projects.

The principal characteristic of a fully developed sector program is that all significant funding for a designated sector should support a single sector policy and expenditure program, under the recipient government's leadership. By requiring recipients to develop their own sector strategies, the assumption is that sectorwide approaches will enhance country ownership. A condition for assuming ownership, however, is the presence of sound policies, such as reasonable macroeconomic and budget policies; a supportive environment for private sector development; and a role for the public sector that is consistent with the government's management and financial capacity. Donors may have to work closely with the recipients to develop the needed policy environment. An Australian Agency for International Development document noted that there are five stages in moving toward a process of progressively strengthening government sector management. The progression depends on achieving milestones related to improved effectiveness in government budget management. The stages range from the first step, in which a donor provides project-based assistance and implementation within an agreed policy framework, to the

[34] *New Approaches to Development Co-operation: What can we learn from experience with implementing Sector Wide Approaches?*, Working Paper 140 (London, England: Overseas Development Institute, Centre for Aid and Public Expenditure, Oct. 2000).

fifth step of supporting a sector program with a common financing mechanism. Another benefit of having a coherent sector strategy under the recipient government's leadership is that donors support the sector under a common framework, thus minimizing the problems of poor coordination.

Two reports[35] identified the following conditions for making sectorwide approaches successful:

- Sectorwide approaches are more relevant for countries and sectors in which donors' contributions are large enough to create coordination difficulties. These approaches are less desirable if aid is only a small share of the budget.
- Sectorwide approaches are potentially more useful when applied to those sectors in which there exists greater agreement among donors and recipients regarding the need for a strong government role in the financing, planning, and delivery of services, hence the dominance of health and education.
- Supportive macroeconomic and budget frameworks must be in place because there is a longer time frame.
- Donors should not dismiss out of hand sectorwide approaches due to a perceived lack of recipient capacity. The best strategy may be to strengthen the sector capacity.
- Sectorwide approaches have been more successful in certain areas, such as health and education, and have tended to fail when attempting to address crosscutting themes, such as the environment, or sectors in which there is a great deal of disagreement about the proper role of government, such as the agriculture sector. These themes need to be incorporated into various sector programs, rather than having their own sectorwide approaches.
- Sectorwide approaches are more likely to be successful where public expenditure is a major feature of the sector and where the donor contribution is large enough for coordination to be a problem (where aid forms more than 10 percent of GDP).

As of June 2000, there were about 80 sector programs being prepared and implemented, mostly in Africa, according to the Overseas Development Institute. The approaches are found exclusively in highly aid-dependent

[35] *Improving Aid Effectiveness: What Role for Sector-Wide Approaches?* (USAID, discussion draft paper as of June 15, 2001) and *New Approaches to Development Co-operation: What can we learn from experience with implementing Sector Wide Approaches?*

poor countries. More than half of the approaches have been in the health and education sectors. Thus far, Australia is the only bilateral donor to take a sectorwide approach in the Pacific, and this is a limited pilot project that has not been evaluated.

In addition, from a recent survey of 16 sector programs, more than 80 percent of the aid provided was in the form of traditional project assistance, making use of individual donor procedures, and just 17 percent was given in the form of sector budget support. These results may reflect documents on sectorwide assistance, which describe donors moving from project assistance strategies to a sectorwide approach. The U.S. proposal to the FSM and the RMI, by contrast, would shift from a budget support strategy to a sectorwide approach.

Appendix VI: 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
MINISTRY OF FOREIGN AFFAIRS
P.O. BOX 1349
MAJURO, MARSHALL ISLANDS 96960

July 19, 2001

Loren Yager
Director
International Affairs and Trade
General Accounting Office
Washington, DC 20548

Dear Director Yager,

At the direction of President Note, I am pleased to respond on behalf of the Government of the Republic of the Marshall Islands (RMI) to the GAO draft report, Foreign Assistance: Lessons Learned From Donors' Experience In the Pacific Region. I would like to take this opportunity to thank your Office for providing a copy of the draft report to the RMI for comment.

The RMI would like to provide several comments in respect to the GAO draft report.

In reference to the GAO figure of $1.7 billion provided to the RMI and FSM under the Compact of Free Association Agreements (page 1). Furthermore, it was also pointed out in the report that "U.S. assistance to the FSM and the RMI, through the Compact of Free Association, is one of three elements (political, economic, and defense) of the Compact. The defense element includes a right granted to the United States by the FSM and the RMI to deny access by third countries for military use" (page 11). In this context, the RMI considers the following point essential in establishing a more complete understanding of the figure mentioned above in respect to the Marshall Islands:

See comment 1.

The U.S. provides economic assistance to the RMI in exchange for military and strategic benefits that the RMI provides to the U.S. However, the report fails to point out that in addition to the strategic denial clause of the Compact, a major element of the U.S. assistance provided to the RMI is towards land rent payment for defense sites in the Marshall Islands. Thus, it is a misrepresentation to state that the $1.7 billion provided under the Compact is "Foreign Assistance".

The RMI would also like to provide the following specific comments in respects to the objective review of the report.

See comment 2.

1. **More explicit recognition that one size does not fit all with economic development assistance.**

   The Asian Development Bank has begun to recognize the inherent differences among Pacific islands states and how these differences can potentially impact development programs and projects. The paper discusses the one size fits all approach of the Compact of Free Association with Palau, RMI and FSM. The U.S. is stressing the new sectorial approach and should recognize the different environments and resources that will impact development in the RMI and the FSM under the re-negotiated Compact. A document or aid package that stresses the same sectors in the RMI and FSM will be missing out on the important points learned from the ADB. Different factor endowments will dictate different approaches toward development. These factor endowments will also have impact on the eventual success or failure of economic development programs and projects. In terms of development and the potential for development there are important differences that must be recognized by the United States when considering the different development paths in the RMI and FSM. There must be some understanding as to how these differences will impact the sectorial approach being developed by the United States for the Compact.

   For example, since RMI has little in terms of natural resources on land, the development of the Marshall Islands Intergenerational Trust Fund should have more weight assigned towards its future development, than say agriculture. This natural resource situation may not be so lopsided in the FSM. However, when the topic of the environment is brought up, what is being considered? In the RMI issues of marine resources and their management should be a major focal point in the discussion. Again, the assignments of weights, or relative value, should be explored; to what extent are programs delivered for natural resource development and protection and marine resource development and protection? Every development topic or sector needs to be evaluated in this manner.

2. **In theory and practice, what are the strengths and weaknesses of the sector based aid delivery approach?**

   There is discussion on the sector-based approach and how it could strike a balance between flexibility and accountability. But there is little evidence provided. The report mentions that this sector-based approach is being applied on a pilot basis only in Papua New Guinea in the health sector. The report mentions there has been substantial literature produced over the last two decades as well as

See comment 3.

experience with program implementation in Africa. The report also mentions that it appears where sectors are well defined the sector approach has the potential to work well. In those areas where it appears sectors are less well defined, such as capacity building and the environment, program implementation can be problematic.

There should be a section that surveys the development literature concerning the sectorial approach for aid delivery. What are the strengths and weaknesses of this approach? What has been learned in Africa that MIGHT be applicable to the Pacific region and the RMI/FSM more specifically? As for the Pacific, there is only one pilot program in the entire region, PNG with health programs, but no evaluation or partial evaluation of results. Therefore, in order to make a more appropriate response to this proposed sector based aid delivery policy, more information and evaluation of work in Africa should be undertaken so a more thoughtful Pacific plan can be thought out and developed. The report makes allusions to these sector development topics, but the reader is left without much tangible, experienced based, insight on this important and timely policy matter.

The RMI Government hopes that the comments provided will assist the GAO in finalizing the draft report and looks forward to seeing these issues incorporated and explained thoroughly in the final report.

Sincerely,

Gerald Zackios
Minister of Foreign Affairs

The following are GAO's comments on the letter from the Republic of the Marshall Islands dated July 19, 2001.

GAO Comments

1. We have added text on page 6 of this report to recognize that portions of the Compact economic assistance to the RMI are used for payments related to the U.S. military presence at the Kwajalein Atoll. A 1982 Land Use Agreement between the RMI government and an organization of Kwajalein landowners obligated the government to make payments to the landowners. In fiscal year 1998, for example, the RMI government paid about $8 million in Compact assistance to the landowners.

2. Our report clearly acknowledges that donors need to tailor their strategies to the individual characteristics of the recipient nations. Page 15 describes the ADB's subregional approach to development, on the basis of Pacific Island characteristics. On pages 19 and 20, we suggest that tailored strategies may be more effective because they are more likely to ensure recipient commitment.

3. We highlighted Australia's pilot project to support the health sector in Papua New Guinea as a sectorwide approach in the Pacific. However, because the United States is proposing sector grants for the RMI and the FSM, we included additional information about sectorwide approaches in appendix V. The appendix summarizes some development conditions that could help sectorwide approaches succeed. We relied on reports that summarized donor experiences with these approaches for this information and did not evaluate individual country approaches outside of the Pacific region. Additional information on selected sectorwide approaches can be found in (1) *New Approaches to Development Co-operation: What can we learn from experience with implementing Sector Wide Approaches?* and (2) *The Status of Sector Wide Approaches.*[36]

[36]*The Status of Sector Wide Approaches*, Working Paper 142 (London, England: Overseas Development Institute, Center for Aid and Public Expenditure, Jan. 2001).

Appendix VII: 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

Office of the Ambassador

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

July 19, 2001

Mr. Loren Yager
Director, International Affairs and Trade
United States General Accounting Office
Washington, DC 20548

Dear Mr. Yager:

In response to your communication of June 28, 2001, it is with pleasure that I relay the following comments to the General Accounting Office on behalf of the Government of the Federated States of Micronesia (FSM). We certainly appreciate the opportunity to comment on the July 2001 GAO Report entitled "Foreign Assistance: Lessons Learned from Donors' Experience in the Pacific Region".

In general, we find the report to be well researched and expect that it will be very useful to its intended recipients as they consider the future of US support to the development of the FSM under the Compact of Free Association.

For clarity and ease of reference, we have listed the concerns numerically and generally in order in which they appear within the report.

1. The first concern we have is with the extent to which the ADB classification of island nations is used in identifying appropriate strategies for development and for donor assistance.

Too much emphasis may be placed on the differences between the FSM and "atoll nations" such as the Marshall Islands and Kiribati. One should not lose sight of the fact that a substantial portion of the population of the FSM resides in the outer islands, most of which are low-lying atolls. One could also question other aspects of the ADB classification criteria, particularly as concerns service delivery to the outer island populations.

The greater "resource potential" of the FSM is largely limited to the larger land area available on the high islands. This allows for a greater potential for agricultural production, and avoids the overcrowding that one sees in south Tarawa in Kiribati and on Ebeye and Majuro in the Marshalls. At the same time, the FSM does not have anything like the land, mineral and other resources of larger island nations such as Fiji, the Solomons, Vanuatu and Papua New Guinea. For that matter, the FSM does not have anything similar to the military installations on Kwajelein, which are a resource of large and long-term value to the RMI.

The reference to the ADB strategies vis-à-vis different categories of island nations could also be misleading with regard to the role that could be played by trust funds. The ADB classification only specifically mentions trust funds in the context of the atoll nations, but this would seem to be more of an oversight than a suggestion that they would be inappropriate elsewhere. The ADB and other multilateral donors have consistently supported the development of a trust fund in the FSM, in order to provide a sustainable basis for the provision of key government services.

See comment 1.

2. We express concern that the report does not recognize the significantly improved conditions in the FSM. Any observer familiar with the FSM in the Trust Territory period would have to acknowledge that very visible progress that has been made since that time.

See comment 2.

3. The report discusses aid and donation histories of 14 other pacific island nations, places with which the FSM has little or no cultural, geographic or historical ties. The juxtaposition of the FSM with these other nations does a disservice, because it fails to distinguish the unique aspects of our nation's history that set us apart from other recipient nations. There is no reference to the historical or political obligation of the United States to provide assistance and nothing to distinguish the FSM from other pacific island nations. On page 7 of the report, there is discussion of 11.9 billion in aide to pacific island nations, supported by the documents found in the FSM, RMI and OECD records. This seems to imply that the FSM is a recipient of considerably more support than we actually receive.

See comment 3.

4. On page 12 of the report, it states "a former adviser to the U.S. negotiator for the current Compact said that, initially, the Compact was largely an exchange of money for defense rights". We are concerned by this somewhat simplistic view as there were a number of other factors affecting the original negotiations. We recommend that a more comprehensive background account of the reasons (political, economical, and historical) for the Compact between the U.S. and the FSM be included in the report.

See comment 4.

5. The report wrongly gives the impression that the FSM is receiving aid from the European Union.

6. We are pleased that the report acknowledges the vulnerability of island nations such as the Federated States of Micronesia to the impact of climate change.

Once again, we express our appreciation for the opportunity to comment on the above – referenced GAO report.

Sincerely,

for Jesse B. Marehalau
Ambassador

cc: T. H. Ieske K. Iehsi, FSM Secretary of Foreign Affairs

The following are GAO's comments on the letter from the Federated States of Micronesia dated July 19, 2001.

GAO Comments

1. The intent of our report was to highlight some of the lessons learned from other donors' experiences with development assistance throughout the Pacific. One of the lessons, which we discuss on page 19 of the report, is that strategies tailored to the individual development conditions of the recipient country are more likely to succeed. In the case of the FSM, this lesson implies that the United States could adopt a new strategy with different assistance levels to reflect improved development conditions.

2. On page 11 of this report, we recognize that many motivations, such as historical ties, guide the distribution of development assistance to the Pacific Island nations. In a previous report,[37] we discussed these historical ties and the current obligation to provide assistance through the Compact of Free Association through fiscal year 2001, with the possibility of extended assistance. Nevertheless, as we note on page 4, the FSM, as a small, island nation in the Pacific, shares similar development challenges with at least 13 other island nations that receive development assistance. Also, beginning with footnote 3 and discussed throughout this report, we note that the major donors provided $11 billion in development assistance to 14 Pacific Island nations. We compiled these data from several sources—the OECD and annual financial audits of the FSM, the RMI, and Palau.

3. Also on page 11, we have replaced the statement, now on pages 11 and 12, with other text to clarify our point that multiple objectives for the Compact may have contributed to reduced expectations for accountability of the assistance. Also on page 12, we recognize that the Compact economic assistance to the FSM and the RMI was part of an agreement that included political and defense elements. The previous report cited in the preceding response discusses these objectives.

4. We agree that the FSM does not receive assistance from the EU and did not report that information. As we note in table 2 of this report,

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

the EU, however, is one of the major multilateral donors to the Pacific Island nations and provided $900 million to islands in the region from 1987 to 1999.

Appendix VIII: GAO Contact and Staff Acknowledgments

GAO Contact

Emil Friberg, Jr., (202) 512-8990

Acknowledgments

In addition to the person named above, Dennis Richards, Jennifer Li Wong, Ron Schwenn, and Rona Mendelsohn made key contributions to this report.

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