

FOR MONTEREY (FINANCIAL ASSISTANCE)

I. Our difficulty with the JCFS position is in part the \$80 million annual figure which is substantially higher than the current level but even more serious is the absence of any indication of a strategy for achieving self-sufficiency. The JCFS proposal has been put forward as "pump priming", but fails to demonstrate how at the end of a ten year period Micronesia would be any closer to self-sufficiency. Indeed, the data presented as back-up for the JCFS position showed the gap between expenditures and revenues growing. Nothing presented during the 7th round would indicate that the 11th year after change in status would be any better than the 10th; quite the contrary.

We could not get approval of such a program; we are equally surprised that the COM has not raised objection on the grounds of increased dependency.

II. In order to determine whether it would be possible to bridge this conceptual gap, we scheduled meetings in Saipan in early February. Mr. Wilson and colleagues met with members of the Joint Committee, technicians from TT Headquarters and TT District governments. These meetings were useful in bringing forward more details, a general exchanging of information, but made only a tentative start at exploring conceptual approaches to economic viability and self-sufficiency. It is for us to determine whether it is now possible to build on these discussions and to come closer together in our thinking and our proposals.

III. It is the U.S. view that Micronesia cannot achieve economic self-sufficiency except by exercising a tight rein on government operating expenditures, and concentrating on policy actions and government programs that are designed to increase domestic production and national income.

This will require a high degree of selectivity and assessment of priorities in making expenditures for social infrastructure projects as well as increased efforts to get users to pay a fair price for government services. In as broad sense it will require harmonizing the rate of social benefits accorded by the Government with the overall development of the economy. It will require higher levels of taxes as well as major private sector contributions to economic infrastructure expansion expenditures.

We feel that the JCFS proposal¹, on the other hand, relies almost exclusively on U.S. Government assistance to not only expand the social and economic infrastructure, but to do this without regard to priorities or an assessment of the social and economic benefits to be derived from the expenditures. The JCFS has not submitted any indication of the economic benefits of these investments, evidence of Micronesias ability to maintain the facilities after completed; or how this all leads to self-sufficiency.

By its own calculations, the JCFS proposal¹ results in higher costs for government operations, as time goes on, without compensating increases in its own revenues. The high level of CIP expenditures results in increasing dependence on external assistance just to keep the country running.

IV. We feel that this is the crux of our problem - the seeming inability of our two sides to communicate on concepts or strategy. Both the 7th round and the Jim Wilson mission failed in this respect. In both cases the JCFS submitted a list of projects - no indication of where these projects lead. It is therefore to this issue we must address ourselves now if we are indeed to break the present impasse in our negotiations.

V. We have reviewed the JCFS report to the COM on the 7th Round; and we have seen Senate Resolution 102 instructing the JCFS to hold out for its financial assistance package. It may be useful for us to comment briefly on this matter.

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A. As we have already stated, we have a fundamental disagreement with the JCFS proposal - it is not a question of bargaining over higher or lower figures. It is a question of arguing over where this all leads to.

With respect to Operations, the JCFS uses 1975 as its base year for looking to the future and increases that substantially, in projecting a first year of new status requirement; we prefer to use 1974 as the base period because (a) the COM had indicated its desire to keep 1975 no higher than 1973; (b) Micronesia already suffers from a disproportionately high level of government operating expenditures in relation to population and national income; and (c) the need to restrain government employment and government salaries in order not to preempt the human resources needed for productive and other income producing undertakings in the private sector.

We believe it to be in Micronesia's long-term interest to hold government operating expenses at the level we have proposed - adjusted, of course, each year for price inflation effects.

B. As for CIP, we are similarly convinced the JCFS proposal is not in Micronesia's own best interests.

In the first instance, we feel it is beyond the capabilities of Micronesia to carry out, over a sustained period of time, a program of this magnitude. If we look at the history of recent years, we find year-end unobligated balance of about \$13 million each year occurring against a considerably lower level of appropriations than that proposed by the JCFS. Actual expenditures, similarly, have been at much lower levels than the program proposed by the JCFS. There is no reason to assume that the level of performance will increase with the change in status and the departure of experienced personnel.

Leaving aside the question of "absorptive capacity", Micronesia will have to consider the impact on current operating expenses of such a large

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capital improvement program. Once built, the costs do not end. One must then provide the recurring annual costs of maintenance, operations, obsolescence, replacement, etc.

It is for these reasons, that the U.S. had proposed a more modest program in the post-Trusteeship period - more in line, we are convinced with priority needs, absorptive capacity, and ability to meet recurring annual costs for upkeep.

In this connection, we are aware that in recent years appropriations for CIP were squeezed below prior year levels because of the \$60 million authorization ceiling on the one hand and the rising costs of government operations, on the other. We therefore are proposing a "catch-up" period starting in FY 1975 and lasting for 3-5 years. In that period, the annual authorization figure will be raised significantly above the \$60 million level, operations costs will be held in check, and these measures will make possible the "putting-in-place" of the essential infrastructure needs of Micronesia before the change in status. This would enable the new government to then fill in the needs for CIP each year on a more orderly scheduling basis as the economy and population grows and as its capacity to finance recurring costs increases.

An important element in this catch-up period is a policy to hold government operating costs down. This will not be easy, especially since the newly completed CIP projects will add to the costs of running the government. This will require a reassessment of how the government finances the services it provides the people. It will require an examination of charges to end users of electricity, water, health services, etc. and it will require an assessment of the tax system.

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VI. Both we and the JCFS agree on the need to increase the present level of government financial assistance to the private sector for economic development projects. We proposed, and the JCFS has accepted, a provision for U.S. Government loans to Micronesia for relending to institutions and private businessmen for projective undertakings.

VII. We are prepared to make an offer of a new financial package in the 8th Round. This will be substantially higher than the 7th round offer (not very far from the JCFS \$80 million figure if that is reduced to a 5 district basis - i.e. \$66.5 million).

A. Operations

Government operations costs will have to be reduced in real terms (i.e., taking into account and making proper adjustments for price inflation) if the goal is truly ultimate self-sufficiency. We estimate the cost of government operations in FY 1974 for five districts plus the costs of the COM, a pro-rata share of relevant headquarters expenditures, and the judiciary, at approximately \$34.5 million. In looking to future funding requirements for Operations, we would have to make two major adjustments in that figure. The first is a reduction to conform with the COM's own intention to reduce overhead costs and reduce the number of relatively expensive expatriates. The second major adjustment is an increase to compensate for world-wide declines in the purchasing power of U.S. currency. We believe we can work out a system for dealing with these adjustments. Let us suggest for discussion purposes, the following approach:

1. Let us assume that the TT Government, with the cooperation of the COM, will reduce, in real terms, the level of expenditures for Operations by at least 10% from their 1974 levels in the years intervening between 1974 and the change in status. That means we would be operating from about a \$31 million base at FY 1974 price levels.

2. Our agreement would state that the U.S. will provide budget support for current operations at \$32 million level based on 1974 prices for a five year period, initially. That each year in those five years, the actual dollar figure would be a result of multiplying \$32 million by a price inflation/deflation factor reflecting changes in the value of the dollar as represented by cost of living indexes in Micronesia.

3. We would adopt a similar formula for succeeding five year periods, changing the \$32 million 1974 base, as we could agree, to accommodate to changes in the local economy and changes in local government revenue.

B. CIP

With respect to CIP, we have examined appropriations from 1966 through 1974. We have made adjustments for eliminating the Marianas and about 1/6th of Territory-wide projects ~~and expenditures~~ to bring the analysis in line with our present negotiating framework.

1. The CIP programs started on a modest scale in 1966, then increased ~~sharply~~ as the appropriation level was elevated over the years to its present \$60 million level and then started to drop sharply, partly in response to demands for Operations funds.

2. In our November analysis in Round 7, we had used the history of the most recent years as the base for projecting requirements in the years following a change in status. We are prepared to consider that CIP requirements may have been constrained in recent years in part because of the squeeze exerted by operating funds rather than solely by the limits on absorptive capacity.

3. We have therefore concurred with the Department of Interior that the 1975, 1976, and 1977 authorization and appropriation levels should be increased to accommodate a significantly larger CIP than was

possible in recent years. This would permit any catching up that is warranted to meet needs that were postponed in recent years, and provide a firm base of infrastructure for Micronesia under a new status.

4. The "adjusted" CIP appropriations for five districts was approximately as follows:

1966 - \$ 3.0 Million

1967 - 6.7 million

1968 - 5.0 million

1969 - 7.3 million

1970 - 18.0 million

1971 - 23.0 million

1972 - 17.0 million

1973 - 14.5 million

1974 - 8.0 million

5. We expect to be able to obtain a level of appropriations in the next 3-5 year period that could permit an average annual level of \$20-\$25 million for CIP. Reduced to 5 districts this might yield something like \$17-\$21 million for Micronesia. This is about the average of the five highest years 1970-1974, which turns out to be about \$16 million, and should therefore clean up any backlog of recent years.

6. We would thereupon propose a \$15 million level for CIP in the first five years of the post trusteeship period as being more in line with the peak period levels that is the JCFS request for \$30 million annually. Again, we would be prepared to consider adjustments in that five year period for effects on the program of price inflation.

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7. In succeeding five year period we would continue CIP assistance, but we visualize the U.S. contributions dropping gradually in line with

(a) reduced priority needs and

(b) increased capacity of Micronesia to finance with its own resources and with funds it can raise on its own abroad.

C. Federal Programs

In November, we had agreed to continue the services of the U.S. Post Office Department, the Weather Bureau, and the Federal Aviation Agency at approximately the same level of activity as will have occurred in the period of the Trusteeship. We confirm that offer now. The JCFS has requested, in addition, certain unspecified support from the U.S. Coast Guard. We regret we are not in a position to commit the Coast Guard to Search and Rescue operations on a regular basis - the U.S. Navy might be able to help out in emergencies.

It is not possible to make commitments with regard to any other Federal programs. They are changing in size and content even with regard to the states and territories of the U.S.; it would therefore be impossible to make any plans for including non-member entities.

D. Economic Development

We share the desire of the people of Micronesia for more rapid economic growth in terms of increased domestic production, more fruitful employment for the work force, and an increasing ability to provide for Micronesia's needs from its own resources. To that end we are now prepared to increase substantially our November offer for economic development loans. You will recall that we had proposed \$2.5 million annually as district loan funds to assist in establishing small private businesses in the districts.

We believe this to be an extremely valuable tool in stimulating local production and local entrepreneurship. We are prepared to increase that amount to \$5 million annually for loans to the central and district governments, ~~development~~. This should help increase Micronesian ownership or joint venture participation in investment projects - such as deep sea fishing; tourist hotels; cattle ranching; copra processing plants, etc., as well as small one family undertakings. Though many of the larger projects could be financed through commercial banking, we recognize the need, in the early days, for softer loan terms and the possibility of increasing the capitalization of the fledgling Micronesian Development Bank. It is view, that this could comprise the most significant element of our financial assistance package in priming the pump for ultimate self-sufficiency. We are prepared, if you agree, to take up with the Department of Interior, the question as to whether we can get started on such a program even before the change in status.

E. U.S. Security Requirements

We will, additionally, pay to the Government of Micronesia the costs that the central government incurs in providing options for land for U.S. strategic use. The cost of such land use will have to be agreed to by the U.S. Government and the whole assistance package outlined above is contingent on our being able to acquire such land at a "reasonable cost".

VIII. In the process of reviewing our differences in the period since Round 7, it occurred to us that the COM might consider obtaining economic advisory services under its own auspices to assist the JCFS and the COM in putting together the different elements in this total economic mosaic. There are real linkages between the costs of operations, the build-up of infrastructure, increased domestic income, and the quality of life. To date, there has

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been, it seems to us, a lack of appreciation for these linkages and causal relationships. Budget officers and architectural planners have predominated - we believe this has tended to produce an uneven and less efficient allocation of financial resources. An economic advisor could help in assessing cost/budget relationships, priorities, and outer limits on government spending. He could also provide advice on how to stimulate economic growth and how to increase the private sector's contribution to the cost of running the government. If the COM elects to obtain such services (either by direct payment or by seeking assistance from international organizations such as ADB or UNDP) we would be happy to have our experts work with such an advisor on a collaborative basis.

IX. In concluding this presentation, we want to point out that the ^{new} U.S. offer is extremely generous. The offer is conditioned on a free association relationship along the lines we have tentatively agreed - a relationship that would be enduring and provide for reciprocal strategic and security benefits.

We are, of course, aware that the JCFS has stipulated that it would require a reexamination of this relationship in the event the U.S. offer of financial assistance comes to less than \$80 million. It is, of course, the right of the JCFS to fix the ground rules for itself. From our standpoint, the offer we would make would be conditioned on a long-term relationship along the lines we have already agreed in Titles 1-3 of the Compact. Any lessening of the ties would be accompanied by declines in financial assistance. An option of complete severance of political association would, obviously result in no compact and no offer of assistance. Going in the opposite direction, closer ties would bring additional benefits.

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Such benefits would be in the form of federal programs, return of federal income taxes collected from U.S. personnel working in Micronesia, and perhaps a higher level of economic development assistance. The budget operations and CIP requirements might be reviewed in light of closer political ties, though we believe our present offer is adequate and probably should not be increased for good economic reasons.

It is for the JCFS to determine in what direction it wishes to go. We have increased our offer ~~substantially~~ from the one made in November - we have made this change - not because we thought our November offer was low - but because we want to demonstrate our good will and wish to give the people of Micronesia an early opportunity to choose its political future.