

**STATEMENT
OF
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DIRECTOR OF THE OFFICE OF INSULAR AFFAIRS
DEPARTMENT OF THE INTERIOR**

BEFORE

**THE HOUSE COMMITTEE ON NATURAL RESOURCES
AND
THE HOUSE COMMITTEE ON FOREIGN AFFAIRS**

ON

SUSTAINING U.S. PACIFIC INSULAR RELATIONSHIPS

SEPTEMBER 26, 2019

Chairman Grijalva, Chairman Engel, Ranking Member Bishop, Ranking Member McCaul, and members of the Natural Resources and Foreign Affairs Committees, I am Nikolao Pula, Director of the Office of Insular Affairs for the Department of the Interior (Department). Thank you for the opportunity to provide the Department's views on the importance of sustaining U.S. relationships with the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau, referred to collectively as the Freely Associated States (FAS). Each of these Pacific Island nations shares a unique, bi-lateral relationship with the United States under special agreements known as Compacts of Free Association (Compacts). The Federated States of Micronesia and the Marshall Islands each signed an original Compact with the United States in 1982 and 1983, respectively, and are now operating under amended Compacts, which were concluded in 2003 and entered into force in 2004. In 1986 Palau signed a Compact with the United States which entered into force in 1994. In 2010, pursuant to that Compact, the United States and Palau signed a Compact Review Agreement (CRA), which was amended and brought into force in 2018.

My colleagues from the Departments of State and Defense will discuss the diplomatic and military importance of the U.S. Government's relationship with the FAS governments. I will focus on (1) the financial assistance the Department provides to the Federated States of Micronesia and the Republic of the Marshall Islands under the 2003 amended Compacts, and to Palau under the 1994 Compact and the 2010 CRA, as amended in 2018.

I. Original Compacts

In 1947, the United Nations placed several Pacific Islands, including the current Federated States of Micronesia (FSM), the Republic of the Marshall Islands (RMI), the Republic of Palau (Palau) under the Trusteeship System established in the U.N. Charter and established the Trust Territory of the Pacific Islands (Trust Territory) with the U.S. as the Administering Authority. This authority was initially carried out by the U.S. Department of the Navy in 1951, the Department

of the Navy transferred to the Department of the Interior the civil administration of the Trust Territory thereby creating a long lasting partnership between the Department and the people of the Trust Territory. The Compacts grew out of this trusteeship relationship with the Trust Territory, and out of a mutual interest that our countries saw in supporting their economic advancement and self-sufficiency. The Compacts originally entered into force in 1986 for the FSM and the RMI and in 1994 for Palau. Funding for sector grants and trust fund contributions as provided for under the Compacts has been administered by the Department.

The Compacts:

- enabled the end of Trust Territory status for each of the Freely Associated States;
- established three stable, sovereign, and democratic states in the Pacific;
- guaranteed the United States the ability to deny access to and use of these three nations by third country militaries; and
- supported close and mutually beneficial government-to-government relationships that contribute to regional security, stability, and prosperity.

II. Amended Compacts for the FSM and the RMI, and the Palau Compact Review Agreement

At the conclusion of the first fifteen-year funding period, the original Compacts with the FSM and the RMI were reviewed and amended. Following the conclusion of the agreements amending the Compacts in 2003, and the passage of Public Law 108-188, the Compact of Free Association Amendments Act of 2003, the agreements amending the Compacts were brought into force in 2004. The Compacts, as amended, provide mandatory economic assistance in fiscal years 2004 through 2023, through the Department of the Interior. The amended Compacts require funding for use in six sectors of development in the FSM and the RMI: 1) education; 2) health; 3) the environment; 4) public-sector capacity building; 5) private-sector development, and 6) infrastructure, with priority given to projects in the education and health sectors.

The Compact relationship with Palau has operated differently from the Compact relationships with the FSM and the RMI, and requires a formal review of its terms as well as the terms of its related agreements by the United States and Palau upon the fifteenth, thirtieth, and fortieth anniversaries of the effective date of the Compact in 1994. In 2010, at the conclusion of the first mandated review, the U.S. and Palau signed an agreement known as the Palau Compact Review Agreement, which contained provisions to provide additional economic assistance. It was fully funded on March 26, 2018, when President Trump signed the 2018 Omnibus Funding Agreement, and following the negotiation of amendments to the funding schedule contained in the 2010 CRA, the CRA and its amendments entered into force in September 2018. Funds under the Compact and the CRA, as amended with Palau, were made available primarily for government operations, a trust fund contribution, and infrastructure projects.

Funding made available under these unique Compacts have provided important economic support, making available the resources to allow the FSM, RMI, and Palau to improve:

- essential government services and infrastructure, while they reform their business climate and fiscal policies, and
- their capacity to govern.

From 1987 – 2003, the FSM and the RMI benefited from Compact assistance totaling approximately \$2.6 billion. Under the amended Compacts, the United States has provided to the FSM and the RMI approximately \$3 billion of economic assistance in fiscal years 2004 - 2019, primarily supporting the delivery of health and education services as well as infrastructure development. Of this amount, approximately \$50 million supports the education sector and \$35 million supports the health sector of each country, annually. For both the FSM and the RMI, the health and education sectors rely principally on federal funding under the amended Compacts. By 2023, the Department will have invested approximately \$170 million of assistance under the amended Compacts into new hospitals and health centers for construction, renovation, and maintenance and \$350 million into new school construction. For the FSM's total revenue, approximately 48 percent derives from grants under the amended Compact or from other federal sources. Figures for two of the four states of Micronesia are even higher: 64 percent for Chuuk and 70 percent for Kosrae. Of the RMI's total revenue, approximately 42 percent derives from grants under the amended Compact or from other Federal sources.

From 1994 - 2009, Palau benefited from Compact assistance totaling approximately \$560 million which included a significant infrastructure project, the circumferential road on Babeldaob, also known as the Palau Compact Road. Under the 2010 CRA, brought into force in 2018, an additional \$229 million was made available to Palau for government operations, infrastructure projects, and to shore up Palau's Trust Fund. Palau's Trust Fund established under Public Law 99-658 and the U.S. Palau Compact, was established as a sinking fund and is managed solely by the Palau Government.

All grant funding provided to the FSM and the RMI under the amended Compacts is reviewed on a semiannual basis in two bilateral, joint economic management committee meetings. As the Director of the Office of Insular Affairs, I chair these meetings, which are known as the Joint Economic Management Committee (JEMCO) for the FSM and the Joint Economic Management and Financial Accountability Committee (JEMFAC) for the RMI. Funding for Palau, on the other hand, under the CRA is provided directly to the Palau government.

Other funding for which the FSM, the RMI, and Palau are eligible is through the Department's Office of Insular Affairs Technical Assistance Program (TAP), which manages discretionary funds provided annually to the Department by the United States Congress. The TAP funding is flexible in its use and application in the FSM, the RMI, and Palau, and can help fill in gaps that the three governments identify that are not covered by the existing Compact support. The U.S. territories, however, are the primary recipients of TAP funding.

III. Trust Funds

As provided for under the amended Compacts, Public Law 108-188, jointly managed Trust Funds were established for both the FSM and the RMI. Federal grant funding has generally decreased annually, paired with increasing contributions to the respective Trust Funds. The Trust

Funds were incorporated in 2004 as non-profit corporations under the laws of the District of Columbia.

Earnings from the Trust Funds were intended to provide an annual source of revenue for the FSM and the RMI Governments after fiscal year 2023 for assistance in education, health care, the environment, public-sector capacity building, private-sector development, and public infrastructure, as described in Section 211 of the amended Compacts, or other sectors as mutually agreed by the United States and the FSM and the RMI, respectively, with priorities in education and health.

The amended Compacts set forth the funding to be contributed to the FSM and RMI Trust Funds until 2023. Trust Fund Agreements outline the organizational structures, policies and procedures for most aspects of the Trust Fund's start-up and ongoing operations. Investment Policy Statements provide investment guidance and are reviewed quarterly and, if required, revised annually.

The U.S. Government maintains a majority of voting members on both Trust Fund Committees. Similar to the JEMCO and the JEMFAC, I also chair the Trust Fund Committees. The Marshall Islands Committee consists of seven members: four U.S. members, including the Chairman; two Marshall Islands members, including the Vice Chairman; and one member appointed by the subsequent contributor, Taiwan. The Federated States of Micronesia Committee has five members total: three U.S. members, including the Chairman, and two Federated States of Micronesia members. Committee meetings are held quarterly throughout the fiscal year.

Under the Compact with Palau, Public Law 99-658, a Trust Fund was also established for Palau. Unlike the Trust Funds for the FSM and the RMI, Palau's Trust Fund was established as a sinking fund and is managed solely by the Palau Government. Under the Compact Review Agreement, the Palau Government is currently restricted to annual withdrawal amounts of no more than \$15 million. As of February 2019, the Palau Trust Fund was valued roughly at \$286 million.

Performance of the FSM and the RMI Trust Funds

Federated States of Micronesia

The balance of the FSM Trust Fund at the end of fiscal year (FY) 2018, the last audited financial year, was \$636.09 million. For FY 2018, the FSM Trust Fund had a dollar-weighted annual investment return of 6.77 percent. Since its inception in 2004, the FSM Trust Fund has had a net return of 5.2 percent. As of the end of FY 2018, the investment of contributions earned \$265.4 million or 71.6 percent of the value of the contributions. No contributor's capital investment has diminished since its inception.

The U.S. Government was obligated to base contributions of \$442.4 million, along with a partial inflation adjustment for fiscal years 2004-2023. The U.S. contribution is \$32.2 million for FY 2019. The U.S. Government has contributed a total of \$372.7 million since inception. In FY 2005, the FSM contributed \$30.3 million, as required under the amended Compact.

The Republic of the Marshall Islands

The balance of the RMI Trust Fund at the end of FY 2018, the last audited financial year, was \$402.43 million. For FY 2018, the RMI Trust Fund had a dollar-weighted annual investment return of 7 percent. Since inception in 2004, it has had a net return of 5.7 percent. As of the end of FY 2018, the investment of contributions earned \$163.7 million or 68.6 percent of the value of the contributions. No contributor's capital investment has diminished since its inception.

The U.S. Government is obligated to contribute \$235 million, along with a partial inflation adjustment, over fiscal years 2004-2023. The U.S. contribution has been \$17.7 million for FY 2019. The U.S. Government has contributed a total of \$195.5 million since inception. In accordance with the amended Compact, the RMI Government contributed \$30 million over fiscal years 2004-2006. They also contributed an additional \$3.2 million for a total of \$33.2 million. Taiwan, an important partner to the Government of the Marshall Islands, sought to support the Trust Fund shortly after it was established and was invited to be a subsequent contributor to the Trust Fund as allowed for under the Compact. Taiwan made its first contribution to the RMI Trust Fund in FY 2005 and has pledged to contribute \$2.4 million per year through FY 2023 for a total of \$40 million. To date, Taiwan has contributed \$30.4 million.

Issues Leading to Fiscal Year 2023 and Beyond

While both the FSM and the RMI Trust Funds have performed up to market standards, there is significant concern about the volatility and the size of the distributions to support post-2023 budgets of the FSM and the RMI. As shown in the May 17, 2018, Government Accountability Office (GAO) report, GAO-18-415, distribution policies that are consistent with both Trust Fund Agreements' current distribution provisions have a high likelihood of resulting in years of limited or zero distributions. This could negatively impact budgetary planning and lead to economic instability in the FSM and the RMI.

According to the GAO, neither Trust Fund is likely to provide consistent distributions comparable to levels of funding similar to fiscal year 2023's annual grant assistance over the long term – estimated for the FSM at \$82 million and for the RMI at \$26.9 million – in the long term post-2023. While it has never been stated as a goal of the Trust Fund to replace grant assistance dollar for dollar, the U.S. Government recognizes that potential levels of zero distribution and significant decreases between levels of grant assistance in FY 2023 and trust fund distribution levels in subsequent years, as is currently projected, could be destabilizing to the governments and their respective economies.

The Trust Fund Committees are analyzing and discussing different distribution policy options to provide more consistent distributions with less volatility and no zero-year distributions; however, as the Trust Fund Committees can only establish distribution policies that are consistent with the Trust Fund Agreement, these options are limited unless the Trust Fund Agreements are amended by the Original Parties to the respective agreements. However, there are implications *vis-à-vis* preserving both Trust Funds for the long-term. Additional time and funding would help to

achieve the right balance between preserving the Trust Funds for decades to come and it would provide consistent and stable distributions without taking on additional risk.

Certain changes to the distribution policy would require amending the respective Trust Fund Agreements. Such changes will require the approval of the respective national governments, including, on the United States' part, an Act of Congress. Other potential changes discussed in the GAO's report are the timing of the distributions, the accountability framework to monitor the distributed funds, and the payment of Trust Fund expenses beyond 2023.

IV. CONCLUSION

Given the important role that Compact grant funding provides to the FSM, the RMI, and Palau, if grant assistance under the amended Compacts and the CRA is allowed to expire by the end of 2023 and 2024, and is not extended, there is the very real risk of adverse impact to the respective economies of these three freely associated states.

The year 2024 marks the 30th anniversary of the Compact agreement between the United States and Palau. Upon this anniversary, the U.S.-Palau Compact requires the U.S. and Palau to again formally review the terms of the Compact and consider the overall nature and development of the relationship. Funding provisions under the 2010 CRA will expire in 2024 and the Executive Branch and Congress must carefully weigh U.S. strategic interests to determine the continued level of funding, if any, it wants dedicated to the relationship. The U.S.-Palau Compact relationship, though different than that with the Federated States of Micronesia and the Marshall Islands, should be considered in conjunction with the FSM and RMI Compacts.

As GAO has identified, uncertainty exists as to the continuity of the range and level of the programs and services provided by federal departments and agencies other than the Department of the Interior such as the U.S. Postal Service, Supplemental Education Grants through the Department of Education, Federal Deposit Insurance Corporation, Federal Emergency Management Agency, various programs through the Department of Health and Human Services, and other federal agencies. However, two principal provisions of the Compacts will continue in force beyond 2023:

- the U.S. military will, as it does now, have responsibility and authority for defense and security matters of or relating to the Federated States of Micronesia, the Marshall Islands, and Palau; and
- as legal non-immigrants, eligible citizens of the Federated States of Micronesia, the Marshall Islands, and Palau will retain the right to enter the United States visa-free and to live, to work, or to study here.

It is important to note that there is a separate provision under the Compact agreement only with the Republic of Marshall Islands – the Military Use and Operating Rights Agreement, that guarantees separate funding through 2066 and military use rights in the Marshall Islands indefinitely.

The United States has provided important economic assistance under all three Compact of Free Association agreements, which has been critical to sustaining the U.S. Government's commitment to these nations and their respective efforts to advance their own economic self-sufficiency and stability. The U.S. can be proud of the historic relationships and the legacy it has with these three Pacific Island nations. Maintaining the close relationships we have developed over the decades, including through all three Compacts, will continue to be an important part of the overall U.S. policy of a free and open Indo-Pacific.