



## **Executive Summary**

The Federated States of Micronesia (FSM) is a lower middle income island nation of less than 103,000 people on 607 islands with a total land area of 271 square miles and an exclusive economic zone (EEZ) of over one million square miles (2.6 million km<sup>2</sup>) in a remote area of the western Pacific Ocean.

The FSM is a former United Nations Trust Territory of the United States that gained independence in 1986. Since then it has operated under a Compact of Free Association (Compact) with the United States, receiving \$80-100 million per year in development funding administered by the Department of the Interior (DOI). The World Bank estimates Gross Domestic Income (GDI) to be \$3,310 per person, but the Pacific Islands Training Initiative (PITI), under a grant from the DOI to monitor the economy for management of the Compact funds, estimates the figure at about \$2,500 per person.

The country currently has no significant exports or domestic industry. It is largely a subsistence economy except in larger towns where the economy is centered on government employment and a small commercial sector. As an isolated Pacific nation, the economy has become dependent on foreign aid and public sector employment. The cash economy is primarily fueled by Compact funds in the form of salaries (more than 50% of employed adults work for the government), and to a much lesser degree by family remittances. Cronyism is common in state and federal employment practices. The cost of doing business is high due to the region's remoteness and dependence on imported goods and services.

Most political power of the nation is delegated to the individual states by the constitution, including regulation of foreign investment, restrictions on leases, distribution of federal tax revenue, and access to Compact funds. There are no political parties. National legislators (senators) are directly elected, and the president and vice-president are selected by the senators from among the four at-large senators. At the state level, all offices are directly elected by the people. Most observers agree that state governors are generally more powerful than the president.

### **1. Openness To, and Restrictions Upon, Foreign Investment**

#### ***Attitude Toward FDI***

While the government of the Federated States of Micronesia (FSM) expresses public interest in finding ways to increase foreign investment, there are many structural impediments to foreign investment and economic progress in general that would require constitutional changes, unlikely in the foreseeable future. Many political leaders at both the state and national level are owners of the largest businesses on the islands, and strongly oppose the needed structural changes that would increase competition to their own interests. The FSM scores in the lowest quintile in almost all measures of economic activity and the climate for doing business.

The most important impediments derive from land and contract issues. Foreign ownership of land is prohibited, and much of the land is owned and passed on within the clan structure, leading to conflicting title claims, the need to negotiate leases with multiple parties, and the possibility of dramatic changes when the original senior lessor dies. There is no system for land title insurance in any of the four states. The combination of these factors placed the FSM at 189 out of 189 in registering property in the World Bank Doing Business report.

Courts nominally support contractual agreements, but enforcement of judicial decisions has been historically weak. Foreign firms doing business in the FSM have had difficulty in collecting debts owed by FSM companies and individuals, even after obtaining favorable judgments. For these reasons, the World Bank ranks the FSM very low in protecting investors (178), resolving insolvency (168), and enforcing contracts (152). U.S. companies and individuals considering dealing with parties in the FSM should exercise due diligence and negotiate minimal credit and payment arrangements that fully protect their interests.

There have been no investment policy reviews conducted by UNCTAD, WTO, or OECD.

### ***Laws/Regulation of FDI***

The individual states directly regulate all foreign investment, except in the areas of deep ocean fishing, banking, insurance, air travel, and international shipping, which are regulated at the federal level. FSM governments use a traffic light system to regulate businesses, with red for prohibited, amber for restricted, and green for unrestricted. The definitions for industries in this system vary from state to state. This means that a venture planning to operate in more than one state must obtain separate permits in each state and perhaps follow different regulations as well.

#### ***FSM Federal***

Red: Arms manufacture, minting of currency, nuclear power, radioactive goods.

Amber: Increased scrutiny before approval for non-traditional banking services and insurance.

Green: Banking, fishing, air transport, international shipping.

#### ***Kosrae State***

Red: Manufacturing of toxic, biohazard materials, gambling, casinos, fishing using sodium/cyanide compressed air.

Amber: Real estate brokerage, non-ecology-based tourism, trade in reef fish, coral harvesting

Green: Eco-tourism, export of local goods, professional services.

### ***Pohnpei State***

Red: None presently defined, determined by board from amber candidates.

Amber: Everything not classified as green.

Green: Businesses with greater than 60% share owned by FSM citizens, initial capitalization of \$250,000 or more, professional services with capitalization of \$50,000 or more, and “Special Investment Sector” businesses with 51% FSM ownership in retail, trade, and exploration, development, and extraction of land or marine based mineral resources or naturally occurring timber.

### ***Chuuk State***

Red: Determined by Director, none codified in law.

Amber: Casinos, lotteries, industries that pollute the environment, destroy local culture and tradition, or deplete natural resources.

Green: Eco-tourism, professional services, intra-state airline services, exports of local goods.

### ***Yap State***

Red: Manufacturing of toxic materials, weapons, ammunition, commercial export of reef fish, activities injurious to the health and welfare of the citizens of Yap.

Amber: None at present

Green: All others

### ***Industrial Strategy***

There is no government agency tasked with developing an industrial strategy; however the 2023 Planning Committee, organized by the president, is tasked with making recommendations for projects to stimulate growth in the private sector. The only significant industry owned by the government, the FSM Petroleum Corporation (FSMPC), organized to fill the gasoline and diesel supply gap when Mobil Oil left the local market, is planning to expand into renewable energy technologies like solar power. Politicians continually call for expansion of the tourism sector, but have created no tax or licensing incentives to encourage investment. Considering the remoteness of the FSM, land ownership prohibitions, and business ownership restrictions, tourism is not likely to grow except in narrow niche markets like scuba diving.

### ***Limits on Foreign Control***

All of the states have limits on foreign ownership of small- and medium-size businesses. Large projects are assessed on a case-by-case basis. The states require separate applications for foreign investment permits. Foreign investment is strictly limited by local ownership (51-60%) or a residency requirement of more than five years. Local small- and medium-size businesses are protected from foreign competition, and larger projects in a business sector already owned by political figures will face strong opposition. Large and unrealistic development proposals have been received enthusiastically by politicians, but have not moved forward primarily due to land issues.

### ***Investment Trends***

At present, there is little new foreign private investment in the FSM. Recent foreign private investment in the FSM has been limited to very small-scale family businesses funded by remittances from overseas family members, or expatriate marriages to locals with the business registered through local family members.

The FSM maintains a website for the promotion of foreign investment that provides some basic information on the application process: <http://www.fsmgov.org/info/fi.html>. There is also an “Investment Guide” planned for the Department of Resources and Development website at <http://www.fsmrd.fm>. At last check it was not yet operational. No foreign investment incentives were reported. Individual states also maintain varying information online about doing business in their state.

### **Table 1 and Table 1B**

**TABLE 1: International indices and rankings**

<b>Measure</b>	<b>Year</b>	<b>Rank or value</b>	<b>Website Address</b>
TI Corruption Perceptions index	2013	Not ranked	<a href="http://cpi.transparency.org/cpi2013/results/">http://cpi.transparency.org/cpi2013/results/</a>
Heritage Foundation’s Economic Freedom index	2013	(153 of 177)	<a href="http://www.heritage.org/index/ranking">http://www.heritage.org/index/ranking</a>
World Bank’s Doing Business Report “Ease of Doing Business”	2013	(156 of 189)	<a href="http://doingbusiness.org/rankings">http://doingbusiness.org/rankings</a>

Global Innovation Index	2013	Not ranked	<a href="http://www.globalinnovationindex.org/content.aspx?page=gii-full-report-2013#pdfopener">http://www.globalinnovationindex.org/content.aspx?page=gii-full-report-2013#pdfopener</a>
World Bank GNI per capita	2012	\$3,230	<a href="http://data.worldbank.org/indicator/NY.GNP">http://data.worldbank.org/indicator/NY.GNP.</a>

**TABLE 1B - Scorecards:** The Millennium Challenge Corporation, a U.S. Government entity charged with delivering development grants to countries that have demonstrated a commitment to reform, produced scorecards for countries with a 2012 per capita gross national income (GNI) or \$4,085 or less. A list of countries/economies with MCC scorecards and links to those scorecards is available here: <http://www.mcc.gov/pages/selection/scorecards>. Details on each of the MCC's indicators and a guide to reading the scorecards are available at: <http://www.mcc.gov/documents/reports/reference-2013001142401-fy14-guide-to-the-indicators.pdf>

## **2. Conversion and Transfer Policies**

The currency of the Federates States of Micronesia is the U.S. dollar. The only two banks operating in the country at present are the Bank of Guam and the Bank of the FSM, both of which are FDIC insured. There are no specific restrictions on repatriating profits from a business, except in Chuuk, where an amount greater than \$50,000 requires approval by the state.

Statistics on family level remittances are difficult to obtain, with various studies reporting from \$3 to \$14 million per year entering the FSM. However, remittances travel freely into and out of the country. Micronesians in US territories send money to their families in the FSM, while Filipino professionals and laborers send money to their families in the Philippines.

## **3. Expropriation and Compensation**

There has been no history of expropriation. The FSM Foreign Investment Act of 1997 guarantees that there will be no compulsory acquisition or expropriation of property of any foreign investment for which a Foreign Investment Permit has been issued, except for violation of laws and regulations and in certain extraordinary circumstances. Those extraordinary circumstances include cases in which such action would be consistent with existing FSM eminent domain law, cases in which such action is necessary to serve overriding national interests, or cases in which either the FSM Congress or the FSM Secretary of Resources and Development has initiated expropriation.

## **4. Dispute Settlement**

The FSM follows the U.S. legal system in theory. The judiciary is independent, but weak, and lacks the ability to enforce decisions. Disputes take years to resolve and still may not produce concrete results. Some cases have been on the docket, with no or little movement, for thirty years or more. There are no provisions under FSM Federal law for alternative dispute resolution. This is also true of the states, with the exception of Kosrae where an alternative dispute

resolution system has taken the place of a small claims court. A bankruptcy law exists since 2005, and has been used by a local service provider to evade collection of social security payments for his employees by the national government. Judgments from foreign jurisdictions are not enforceable in FSM courts. Although the FSM signed the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (**ICSID**) on June 24, 1993, there have been no cases so far.

## **5. Performance Requirements and Investment Incentives**

There are currently no defined performance requirements for investments, and no government incentives to attract investment.

## **6. Right to Private Ownership and Establishment**

The rights of private property and establishment are protected for FSM citizens, and to a much lesser degree for foreign nationals who have more than five years residence in the country. The legal system has tended to favor local partners in joint ventures. Under the Compact of Free Association, U.S. citizens do not require visas, residence permits, or work permits to live or work in the FSM, but are severely limited in their ability to register businesses.

## **7. Protection of Property Rights**

Protection of real property is not applicable to foreign nationals. Intellectual property is nominally protected, and the FSM is a member state of the World Intellectual Property Organization (WIPO), and the country is not listed on the USTR Special 301 Report for 2014. However, a small CD/DVD pirating market exists, and local business have used well-known trademarked names for their stores.

## **8. Transparency of the Regulatory System**

The FSM is not a signatory to any convention on transparency in international investment. Transparency of government actions is typically based more on personalities than on the law. Regulatory bodies sometimes involve themselves in issues beyond their jurisdiction. Conversely, other regulations are not uniformly enforced. It is often difficult to obtain public records, as there are no Freedom of Information or Sunshine Laws in the FSM, although some states and government organizations do require open meetings. In addition, government audits and statistical reports are not prepared promptly and current data is often not available. Two websites provide relatively recent (if not comprehensive) data and reports: <http://www.sboc.fm/> and <http://www.fsmopa.fm>. Similarly, it has been reported that obtaining licenses and permits in a

timely manner may depend more on the relationship of the investor (or local legal counsel) with the official in charge than any clear procedure or timeline.

## **9. Efficient Capital Markets and Portfolio Investment**

There is no stock or commodities exchange. Little credit is available locally. Banks make relatively small and short-term local loans because of the difficulties inherent in collecting debts and obtaining collateral that could be attached and sold in the event of default. As a result, banks move a large share of deposits to U.S. financial markets. Because most businesses are family owned, there are no shares that could be acquired for mergers, acquisitions, or hostile takeovers. A secured transaction law was signed by the FSM President in November 2005 and a filing office is in operation since October 2006.

## **10. Competition from State-Owned Enterprises**

The FSM established state monopolies in the areas of fuel distribution, telecommunications, and copra production. The companies respectively are the FSM Petroleum Corporation (FSMPC), the FSM Telecommunications Corporation, and the FSM Coconut Development Authority, which was recently dissolved by Congress and folded into the FSMPC. Recent legislation liberalized the telecommunications market, allowing for competition in order to qualify for World Bank funding for a submarine fiber optic cable to Yap and Palau.

## **11. Corporate Social Responsibility**

There is little awareness of corporate responsibility in the FSM, however most local businesses are small and generally responsible in the community in which they operate. There are only a limited number of multi-national companies operating in the FSM and all are foreign-owned. Companies that are U.S.-based do generally follow CSR principals.

## **12. Political Violence**

The Federated States of Micronesia enjoy a stable, democratic form of government. Under the Amended Compact of Free Association, the U.S. Government guarantees the FSM's external security. There is no history of political violence in the FSM.

## **13. Corruption**

The FSM has laws prohibiting corruption and there are penalties for corrupt acts. The National Office of the Public Auditor, with support from the FSM Department of Justice, has been the entity most active in anti-corruption activities. A number of senior ex-FSM Government officials



have been convicted of corruption under the FSM Financial Management Act, usually involving procurement fraud. Corruption is not a predicate offense under the money laundering statute. Bribery is punishable by imprisonment for not more than ten years and disqualification from holding any position in the FSM Government. The FSM has not signed or ratified the UN Convention on Corruption. Given that many FSM National, State, and Municipal Government officials also own businesses, there exists significant potential for conflicts of interest. One local NGO, Micronesian Seminar, has prepared an anti-corruption video that has received wide play. The U.S. Embassy is not aware of any other significant anti-corruption efforts. The degree to which government officials accept direct bribes is unknown, however misuse and misappropriation of government funds is widespread.

#### **14. Bilateral Investment Agreements**

No bilateral investment agreement exists between the United States and the FSM. The Compact of Free Association, As Amended, is the only applicable guidance. Under this treaty, articles from the United States imported into the FSM are guaranteed to receive treatment that is no less favorable than any other foreign country. Articles exported from the FSM to the U.S. are duty exempt, with a number of exceptions as listed in Article IV, Section 242.

#### **15. OPIC and Other Investment Insurance Programs**

The FSM signed a bilateral agreement with OPIC in 1988, but there are no current OPIC financing projects listed for Micronesia on their website: [www.opic.gov](http://www.opic.gov).

#### **16. Labor**

Wages are very low, with minimum wage laws for government employees in all states and the federal government. Only Pohnpei has a minimum wage for the private sector at \$1.75 per hour. Employment in the public sector is preferred because the wages are significantly higher. The minimum hourly wage for employment with the national government is \$2.65. The minimum hourly wage for government workers in the individual states is: Pohnpei \$2.00, Chuuk \$1.25, Kosrae \$1.42, and Yap \$1.60.

There are no laws regulating hours of work (although a 40 hour work week is standard practice) or prescribing standards of occupational safety and health. A federal regulation requires that employers provide a safe workplace. Neither the Department of Health nor the Environmental Protection Agency has enforcement capability, and working conditions vary in practice. There is no law for either the public or private sector that permits workers to remove themselves from dangerous work situations without jeopardy to their continued employment.

There are few FSM citizens with skills to perform tasks of any technical nature. Expatriate workers are typically hired to fulfill these roles. The vast majority of doctors, nurses, accountants, lawyers, engineers, construction foremen, or even construction machine operators are foreign workers.

**17. Foreign Trade Zones/Free Ports**

There are no Foreign Trade Zones, Free Trade Zones, or Free Ports in the FSM.

**18. Foreign Direct Investment and Foreign Portfolio Investment Statistics**

**TABLE 2: Key Macroeconomic data, U.S. FDI in host country/economy**

	FSM Office of SBOC		World Bank and PITI		Source of data
<b>Economic Data</b>	Year	Amount	Year	Amount	
Host Country Gross Domestic Product (GDP) ( <i>Millions U.S. Dollars</i> )	2010	\$297.5	2012	\$326.2	<a href="http://www.worldbank.org">http://www.worldbank.org</a>
			2012	\$247.4	<a href="#">FSM/SBOC</a> <a href="#">Pacific Islands Training Initiative</a>
<b>Foreign Direct Investment</b>	Host Country Statistical source*		USG statistical sources		Source of data
U.S. FDI in partner country ( <i>Millions U.S. Dollars, stock positions</i> )	No reliable local statistics available	unknown	2012	Not shown	<a href="#">Department of Commerce/Bureau of Economic Analysis</a>
			2012	\$1	<a href="#">Pacific Islands Training Initiative</a>
Host country's FDI in the United States ( <i>Millions U.S. Dollars, stock positions</i> )	n/a	unknown		Not listed	<a href="#">Department of Commerce/Bureau of Economic Analysis</a>  • Insignificant level
Total inbound stock of FDI as %	n/a	n/a	n/a	n/a	

host GDP <i>(calculate)</i>					
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Figures for GDP vary greatly, due to poor collection of statistics. PITI at the Graduate School USA provides economic reporting of the Pacific Islands under a grant from the DOI, which oversees the Compact development funding. Their figures are generally more reliable. Note that the Compact funding from the United States of roughly \$80 million per year is **not classified as foreign aid**, but cover operational costs (salaries), sector development and infrastructure investment and **are included in the GDP**.

**TABLE 3: Sources and Destination of FDI**

According to IMF data, South Korea reports outbound investment of \$1 million to the FSM as of 2012. The United States reported \$30 million outbound FDI. However, neither of these amounts was reported by the FSM as inbound FDI.

The FSM reports no outbound FDI, although Mauritius reports -\$16 million, Mexico reports \$1 million, and Singapore reports \$13 million in inbound investment from the FSM.

**TABLE 4: Sources of Portfolio Investment**

There are no reports of portfolio investment entering or leaving the FSM.

**19. Contact Point at Post for Public Inquiries**

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