

**The Compact of Free Association and Development in the Freely Associated States**

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The United States' relationship with the Marshall Islands, Micronesia, and Palau is unlike that with any other state. These three countries are freely associated states (FAS) of the US, meaning that they remain sovereign while ceding authority over security and defense matters to the US in exchange for economic aid grants. The treaties which govern this unique arrangement are known as the Compact of Free Association. However, the nature of the Compact is a debated issue among researchers: some see it as a mutually beneficial relationship, others describe it as a case of neo-colonial exploitation, and still others view it as an unsuccessful attempt by the US to promote development in the FAS. This study employs economic data to better understand how the Compact has impacted economic development in these countries. This data reveals that development has been limited and slow, and that the FAS remain dependent on American funding. However, dependency appears to be decreasing, and self-sufficiency is still possible for these states. With Compact grants ending in 2023 and 2024 and the treaties being renegotiated, it is helpful to understand how these grants have affected the economies of the FAS.

The relationship between the United States and the islands which would become the freely associated states goes back to World War II. After the war, the United Nations established a trust territory under US control which encompassed what is now the sovereign states of the Marshall Islands, Micronesia, and Palau, as well as the American territory of the Northern Mariana Islands. As status negotiations unfolded during the 1970s, The Marshall Islands and Palau chose to pursue independence separately while the Northern Marianas voted to be annexed into the United States; the remaining districts of the trust territory formed the Federated States of Micronesia. In 1980, the US reached an agreement with the three states in which they would become independent states in free association with the US.<sup>1</sup> Free association refers to a

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<sup>1</sup> J. Ross Macdonald, "Termination of the Strategic Trusteeship: Free Association, the United Nations and International Law," *Brooklyn Journal of International Law* 7 (1981): 238.

relationship in which one sovereign state voluntarily cedes certain government responsibilities, in this case security and defense, to another. This agreement formed the framework for what would become the Compact of Free Association.

In 1986, the Marshall Islands and Micronesia became independent under the terms of the Compact of Free Association.<sup>2</sup> This treaty was set to expire after fifteen years, and at its most fundamental level was an agreement for the US to give the FAS financial aid for economic development in exchange for complete authority over security and defense within their territories. Palau achieved independence and a Compact of its own in 1994. However, its treaty had a somewhat different structure than that with the Marshall Islands and Micronesia, establishing a trust fund to complement development aid.<sup>3</sup> As a result of its different timeline and funding structure, the Compact with Palau is often considered separately from the Compact with the Marshall Islands and Micronesia. However, its motivations and the intended benefits to its signatories remain the same.

To begin, the Compact's primary benefit to the United States has always been military. The US has "full authority and responsibility for security and defense matters" in the freely associated states.<sup>4</sup> The most significant United States security interest in the FAS is the Reagan Test Site at Kwajalein Atoll in the Marshall Islands, which is used for testing ballistic missiles and missile defense systems. The US has leased the test site through 2066, with payments for this lease constituting an additional source of Compact funding for the Marshall Islands.<sup>5</sup> The US

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<sup>2</sup> "Executive Order 12569 of October 16, 1986, Compact of Free Association With the Republic of the Marshall Islands, the Federated States of Micronesia, and the Republic of Palau," (1986).

<sup>3</sup> Chimene Keitner and W. Michael Reisman, "Free Association: The United States Experience," *Texas International Law Journal* 39 (2003): 51.

<sup>4</sup> U.S. Department of State, *Compact of Free Association*, Signed at Palikir, May 14, 2003.

<sup>5</sup> David Kupferman, "The Republic of the Marshall Islands since 1990," *The Journal of Pacific History* 46, no. 1 (2011): 77.

also has the right to strategic denial, meaning that it can block third parties, such as China, from entering the waters and airspace of the FAS. The Compact is an important part of American security strategy in the Pacific. The United States' exclusive authority over security and defense, and its ability to overrule any FAS action seen as incompatible with this authority, have taken on a renewed importance in light of rising tensions with China.

One of the most important aspects of the Compact for the FAS, on the other hand, is its migration provisions. Citizens of these three countries have the right to permanently live and work in the United States without having to go through the standard immigration process.<sup>6</sup> Migrants living in the US under the Compact were initially eligible for many federal programs, most notably Medicaid, under qualified alien status. However, this status was revoked by the Personal Responsibility and Work Opportunity Act in 1996, much to the surprise of the FAS themselves.<sup>7</sup> Nonetheless, tens of thousands of Compact migrants now live in the US, with most residing in Hawaii, Guam, and the Northern Mariana Islands, as well as a large Marshallese community in northwestern Arkansas.<sup>8</sup>

Even more important than migration are the Compact's provisions for economic aid to the freely associated states. According to the United States government, the goal of this aid was to achieve the interconnected aims of "economic development and self-sufficiency" by the end of the Compact funding period in 2001.<sup>9</sup> In the case of the Marshall Islands and Micronesia, grants were given directly to the countries' governments on an annual basis, with the amount of

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<sup>6</sup> Robert A. Underwood, "The Amended US Compacts of Free Association with the Federated States of Micronesia and the Republic of the Marshall Islands: Less Free, More Compact," *East-West Center*, no. 16 (2003): 8.

<sup>7</sup> Kevin Morris, "Navigating the Compact of Free Association: Three Decades of Supervised Self-Governance," *University of Hawai'i Law Review* 41 (2018): 404.

<sup>8</sup> Michael B. Gerrard, "America's Forgotten Nuclear Waste Dump in the Pacific," *The SAIS Review of International Affairs* 35, no. 1 (2015): 95.

<sup>9</sup> U.S. General Accounting Office, *Compact of Free Association: Negotiations Should Address Aid Effectiveness and Accountability and Migrants' Impact on U.S. Area*, GAO-02-270T, 2001: 7.

money decreasing every five years. Palau's funding arrangement was "front-loaded" such that more than half of the grants were given within the first three years, and a trust fund was established to support the country once aid stopped altogether.<sup>10</sup> These direct government grants were subjected to poor accounting and oversight practices, as well as usage on projects that did not promote economic development.<sup>11</sup> When the Compact was renegotiated in the early 2000s, both the United States and the FAS understood that its financial component had failed to accomplish its development goals.

The new agreements with the Marshall Islands and Micronesia, commonly referred to as Compact II, were signed in 2003, with funding set to last for twenty years. These treaties, like the one with Palau, are bilateral in nature, but because of their near uniformity, the three Compacts are typically treated as a singular entity. Compact II maintained the security and migration provisions of the original treaty but overhauled its economic component to better promote development and self-sufficiency. Starting in 2004, aid was given in the form of sector grants instead of direct government grants. The large majority of this funding, often as much as 80%, goes to the healthcare and education sectors.<sup>12</sup> Along with Compact II, two bodies were established to oversee these grants and ensure that they were being used for development: the Joint Economic Management Committee (JEMCO) with Micronesia and the Joint Economic Management and Financial Accountability Committee (JEMFAC) with the Marshall Islands.<sup>13</sup> Finally, a trust fund was established for after funding ends, mirroring the Compact with Palau.<sup>14</sup>

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<sup>10</sup> Donald R. Shuster, "The Republic of Palau and Its Compact, 1995–2009," *The Journal of Pacific History* 44, no. 3 (2009): 237–8.

<sup>11</sup> Gerard A. Finin, "Associations Freely Chosen: New Geopolitics in the North Pacific," In *The China Alternative: Changing Regional Order in the Pacific Islands*, edited by Graeme Smith and Terence Wesley-Smith, 1st ed., ANU Press, 2021: 173.

<sup>12</sup> Samuel Brazys, "Dutch Disease in the Western Pacific: an overview of the FSM economy under the Amended Compact of Free Association," *Pacific Economic Bulletin* 25, no. 3 (2010): 25.

<sup>13</sup> Finin, "Associations Freely Chosen," 174.

<sup>14</sup> Morris, "Navigating the Compact," 417.

Compact assistance for the Marshall Islands and Micronesia expires in 2023, and funding for Palau ends in 2024.

While it is broadly accepted that the original Compact was unsuccessful, the treaties' impact since 2004 is a debated topic in the scholarly literature. Several key terms exist in this literature which must be defined. First, development refers to the process by which an economy transforms from lower income to higher income. The related concept of dependency denotes a state in which an economy requires continuous outside support in order to continue functioning at its current level. The lack of such reliance, and the inverse of dependency, is self-sufficiency. In the literature on the Compact, these concepts are inseparable; the FAS cannot achieve development without also achieving self-sufficiency, and self-sufficiency is an essential aspect of the concept of development.

A review of the literature reveals three distinct frameworks for understanding how the Compact of Free Association has affected the economies of the freely associated states. The first school of thought views the Compact as a mutually advantageous agreement and contends that it provides a variety of benefits for these states. Researchers who hold this position often advocate for more countries to sign Compact-like agreements, frequently focusing on its potential applications for climate change adaptation. The second framework for understanding the Compact holds that it is an asymmetric and exploitative relationship. Through this lens, the United States uses Compact grants to keep the FAS dependent on aid, allowing the US to take advantage of these states for security purposes. Finally, the third school of thought contends that the Compact is neither mutually beneficial nor intentionally exploitative, but rather tried and failed to promote development and self-sufficiency. Each school of thought has its strengths, but as will be seen, the economic evidence best fits the third framework.

To begin, some scholars have concluded that the Compact of Free Association is a mutually beneficial relationship. Finin (2021), for example, argues that its aid “advances the national interests of each of the parties to the compacts,” with economic development being the primary advantage for the FAS.<sup>15</sup> Friberg (2022) calls not just for this funding to be extended after 2023, but also for the amount of grants to be increased and for FAS citizens to be made eligible for more federal programs.<sup>16</sup> Many of these scholars suggest that more countries, such as Kiribati, Nauru, or even the Philippines should sign Compacts of their own with the US on account of its positive effects.<sup>17</sup> The authors of this school of thought agree that, at least since the reforms of Compact II, the relationship between the US and the FAS has been mutually beneficial.

A notable aspect of this more sanguine framework is its emphasis on potential applications of the Compact for climate resilience and adaptation. Even before Compact II, Curran and Cruz (2002) suggested that the treaty’s grants allowed the FAS to work towards economic development without having to exploit their environments for export production.<sup>18</sup> More recently, it has been proposed that Compact-like agreements could be used to protect other small island states from the territorial and financial impacts of rising sea levels, with grants being used for climate adaptation.<sup>19</sup> Sharon (2021) also finds that the Compact is mutually beneficial and notes that it could be an attractive model for other small island states specifically in light of

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<sup>15</sup> Finin, “Associations Freely Chosen,” 173.

<sup>16</sup> Emil Friberg, “No Time to Lose: Renew the Compacts of Free Association,” *East-West Center*, no. 595 (2022): 2.

<sup>17</sup> Richard K. Pruett, “A United States-Kiribati Compact of Free Association would Yield Mutual Dividends,” *East-West Center*, no. 501 (2020): 1–2.

<sup>18</sup> Sara R. Curran and Maria C. Cruz, “Markets, Population Dynamics, and Coastal Ecosystems,” *Ambio* 31, no. 4 (2002): 374.

<sup>19</sup> Philip G. Dabbagh, “Compact of Free Association-Type Agreements: A Life Preserver for Small Island Sovereignty in an Era of Climate Change,” *Hastings Environmental Law Journal* 24 (2018): 456–8

rising sea levels.<sup>20</sup> The benefits associated with climate adaptation are currently hypothetical, as this sector does not receive grants under the present system. Nonetheless, a significant group of scholars exists who highlight the positive effects of the Compact and view it as a mutually beneficial partnership.

In clear contrast to this first school of thought, many other researchers argue that the Compact of Free Association is an exploitative relationship. For example, Lutz (2006) has long suggested that the treaty is an example of American imperialism and that the freely associated states are under the US's military and economic empire.<sup>21</sup> The 1996 revocation of Medicaid eligibility for Compact migrants is often raised to show that the US is exploiting these states for security purposes and never intended to assist them or their citizens economically.<sup>22</sup> This framework classifies the Compact as an asymmetric and exploitative patron-client relationship in which the FAS' reliance on US funding means they can be pressured to act against their own peoples' interests.<sup>23</sup> Indeed, Puas (2021) concludes that the "Compact has effectively become a tool for the US to pressure the FSM Government to comply with US demands or suffer financial consequences."<sup>24</sup>

The concept of aid dependency is very important to this framework for understanding the Compact. These scholars argue that the United States intentionally uses the treaty's development funding to create dependency and interfere with the self-determination of the FAS.<sup>25</sup> Serrano

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<sup>20</sup> Ori Sharon, "To Be or Not To Be: State Extinction Through Climate Change," *Environmental Law* 51, no. 4 (2021): 1048.

<sup>21</sup> Catherine Lutz, "Empire Is in the Details," *American Ethnologist* 33, no. 4 (2006): 595.

<sup>22</sup> Paul Lyons, Ty P. Kāwika Tengan, and Joakim "Jojo" Peter, "COFA Complex: A Conversation with Joakim 'Jojo' Peter," *American Quarterly* 67, no. 3 (2015): 669.

<sup>23</sup> Wouter P. Veenendaal, "Analyzing the Foreign Policy of Microstates: The Relevance of the International Patron-Client Model," *Foreign Policy Analysis* 13, no. 3 (2017): 567–72.

<sup>24</sup> Gonzaga Puas, *The Federated States of Micronesia's Engagement with the Outside World: Control, Self-Preservation and Continuity*, 1st ed. ANU Press, 2021: 145.

<sup>25</sup> Keola K. Diaz, "The Compact of Free Association (COFA): A history of failures," *University of Hawai'i ScholarSpace* (2012): 32.



(2013), for example, alleges that the Compact promotes an “orchestrated dependency on federal monies” in order to preserve American military control of the region.<sup>26</sup> Furthermore, Bordner et al. (2020) argue that the Compact destroyed local economic structures and replaced them with a “neocolonial aid regime” which creates dependency and deprives the FAS of the ability to manage their own affairs.<sup>27</sup> Overall, this second framework views the Compact as a tool which the United States uses to maintain its dominance over a strategically important region, exploiting the FAS by failing to follow through on pledges of development and using aid to further economic dependence.

The third and final school of thought regarding the Compact of Free Association interprets it as a real attempt by the United States government to promote economic development which has, for various reasons, been unsuccessful. Morris (2018) observes that despite the Compact’s sector grants, health and education outcomes in the freely associated states have not significantly improved. He calls for more oversight of funding in order to increase effectiveness.<sup>28</sup> Others conclude that there is too much oversight, suggesting that JEMCO has been too parsimonious and that its denial of certain grants has impeded development in Micronesia.<sup>29</sup> Additionally, the fact that Palau requested that Congress extend Compact funding from 2009 to 2024, indicates to these scholars that the country is still not economically self-sufficient and that the treaty did not have the expected impact on development.<sup>30</sup>

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<sup>26</sup> Susan K. Serrano, “The Human Costs of Free Association: Socio-Cultural Narratives and the Legal Battle for Micronesian Health in Hawai’i,” *John Marshall Law Review* 47 (2013): 1395.

<sup>27</sup> Autumn S. Bordner, Caroline E. Ferguson, and Leonard Ortolano, “Colonial dynamics limit climate adaptation in Oceania: Perspectives from the Marshall Islands,” *Global Environmental Change* 61 (2020): 4–5.

<sup>28</sup> Morris, “Navigating the Compact,” 413–6.

<sup>29</sup> Clement Yow Mulalap, Michael Lujan Bevacqua, Monica C. Labriola, and Landisang L. Kotaro, “Micronesia in Review: Issues and Events, 1 July 2015 to 30 June 2016,” *The Contemporary Pacific* 29, no. 1 (2017): 95.

<sup>30</sup> Shuster, “The Republic of Palau,” 328.

Several researchers relate the Compact's lack of success to structural issues in the economies of the FAS. These states can be classified as MIRAB economies, meaning that they are structured around migration, remittances, aid, and bureaucracy. In a MIRAB economy, foreign aid, and the public bureaucracy which exists to manage it, crowd out private sector development.<sup>31</sup> Rummel (2017) argues that the Compact is responsible for this economic dependency and that it "constrains economic development to [a] public-sector led pattern."<sup>32</sup> Brazys (2010) invokes the concept of Dutch Disease, which occurs when an excess of foreign aid disincentivizes domestic production of tradable goods, to explain the treaty's effect on Micronesia's economy. He recommends that Compact grants should be targeted at the development of tradable sectors, instead of non-tradable social infrastructure like healthcare and education.<sup>33</sup> This literature reveals that the Compact has affected the FAS' economies by making them dependent on American aid, potentially at the expense of economic development.

The Compact of Free Association's apparent lack of success in promoting development has led some in this third school of thought to propose that it may never have been a realistic goal. Hezel (2012) concludes that development to the point of self-sufficiency is not possible for the FAS and that continuous aid will be necessary for the FAS to remain "viable as modern nation-states."<sup>34</sup> These researchers agree that the FAS are "highly dependent" on Compact grants and that their governments will require continued American funding after 2023.<sup>35</sup> The Compact's

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<sup>31</sup> Emil Friberg, Kendall Schaefer, and Leslie Holen, "US economic assistance to two Micronesian nations: Aid impact, dependency and migration," *Asia Pacific Viewpoint* 47, no. 1 (2006): 126–7.

<sup>32</sup> Ian M. Rummel, "Effects of the Compact of Free Association on sovereignty in the Federated States of Micronesia," *Naval Postgraduate School* (2017): 52.

<sup>33</sup> Brazys, "Dutch Disease," 25–32.

<sup>34</sup> Francis X. Hezel, "Pacific Island Nations: How Viable Are Their Economies?" *Pacific Islands Policy* 7 (2012): 27.

<sup>35</sup> Rens Van Munster, "Free Association: Between Self-Government and Dependence: Some Insights from the Compact of Free Association between the US and the Republic of the Marshall Islands," Danish Institute for International Studies, 2022: 1–2.

shortcomings are attributable to the FAS' geographic isolation and lack of resources, leading them to conclude that "the economic independence envisioned by this funding scheme is unrealistic."<sup>36</sup> In sum, the third framework for understanding the Compact holds that it has been an unsuccessful effort to promote economic development in the freely associated states, with some arguing that success was not possible in the first place.

In order to evaluate the effect of the Compact on the economies of the Marshall Islands, Micronesia, and Palau, it is first necessary to acquire data which can be used to meaningfully measure the key concepts of economic development and dependency. The following study will use several time series drawn from the World Bank and US Government Accountability Office to examine how the Compact has affected development and dependency in the freely associated states from 2004 to 2019. An analysis of this data will reveal that development has been limited and generally confined to the public sector. At the same time, dependency remains high, but has been clearly decreasing since around 2010. Overall, this evidence is most aligned with the theory that the Compact of Free Association has been an unsuccessful effort to promote economic development in the FAS.

Four metrics in particular will be used to measure how the Compact has impacted the economies of the FAS: real gross domestic product (GDP), the ratio of GDP to government revenue, the percentage of government revenue coming from United States aid, and the percentage of GDP coming from US aid. These indicators are derived from the existing Compact literature. The second and third of these metrics are typically calculated using government expenditures, rather than revenue. However, the annual expenditures of the FAS governments are not consistently publicly available, whereas information about their annual revenues going

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<sup>36</sup> U.S. Institute of Peace, "China's Influence on the Freely Associated States of the Northern Pacific," U.S. Institute of Peace, 2022:36.

back to 2004 have been made public. As a result, government revenue will be used in place of expenditures. These values are not necessarily equal, but as will be seen, they are generally comparable in the case of the FAS. Government revenue is a robust substitute for expenditures, and using this value will allow for a much larger sample of data which can be used to shed light on the economic effects of the Compact.

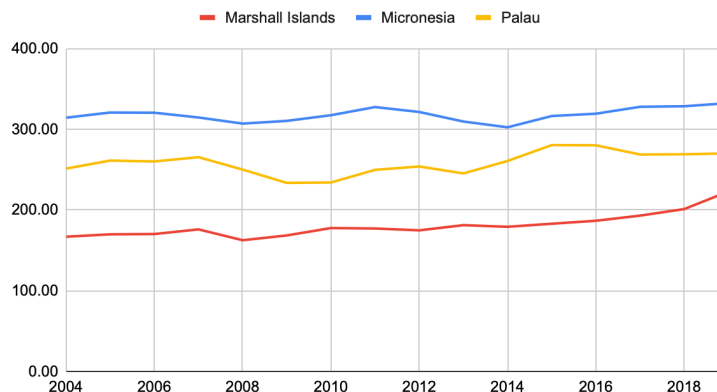
Additionally, when used on its own, GDP will be measured in real terms, adjusted for inflation. However, the ratio of GDP to government revenue and the percentage of GDP coming from US aid will be obtained using nominal GDP instead. This distinction is necessary because the other values, government revenue and US aid, are not already adjusted for inflation. When they are divided alongside nominal GDP, the inflation factor is canceled out, creating an indicator which can be compared across years. If real GDP were used, the derived values would be inaccurate for years before and after the reference year, possibly creating the appearance of a trend which does not actually exist. A final methodological point is that for the purposes of this study, only funding from the US, including Kwajalein lease payments to the Marshall Islands and trust fund payments to Palau, will be considered. The FAS receive some aid from other countries and institutions, but the large majority of funding comes from the US through the Compact. This study seeks to measure the effect of the Compact of Free Association on the economies of the freely associated states, and therefore only Compact aid will be examined.

Two sources will be used to obtain data for this study. First, the World Bank's online DataBank has values for both nominal GDP and real GDP in terms of 2015 United States dollars for all three FAS. The second source of data is a 2022 Government Accountability Office (GAO) report which provides government revenue for each of the FAS, broken down into percentages

by source, from 2004 to 2018.<sup>37</sup> This report also provides the specific amount of Compact funding given to each country for 2015 through 2019.<sup>38</sup> For those five years, the specific value is used, but for 2004 through 2014, the amount of US aid can be easily derived by multiplying total revenue by the percentage of revenue coming from the US. It is helpful that the data goes back to 2004, because that is the year when the Compact II reforms took effect in the Marshall Islands and Micronesia, and the fact that it ends in 2019 is also fortuitous because it excludes the economic impacts of the coronavirus pandemic, which cannot be attributed to the Compact. With this quantitative evidence, it is possible to start investigating how the Compact of Free Association has impacted the economic development of the freely associated states.

To begin, Figure 1 depicts how real GDP, in millions of 2015 United States dollars, has changed from 2004 to 2019 in each of the FAS. Real GDP grew by 33% in the Marshall Islands, but in Palau it only increased by 7% and in

Real GDP, millions of 2015 USD (Figure 1)



Micronesia it grew by just 6%. In other words, GDP growth barely outpaced inflation in these countries. For comparison, according to World Bank data, worldwide real GDP increased by 56% from 2004 to 2019, meaning that economic growth in the FAS is falling behind global growth.<sup>39</sup> Moreover, within the group of eleven peer countries which the World Bank refers to as

<sup>37</sup> U.S. Government Accountability Office, *Compacts of Free Association: Implications of Planned Ending of Some U.S. Economic Assistance*, GAO-22-104436 (2022): 119–21.

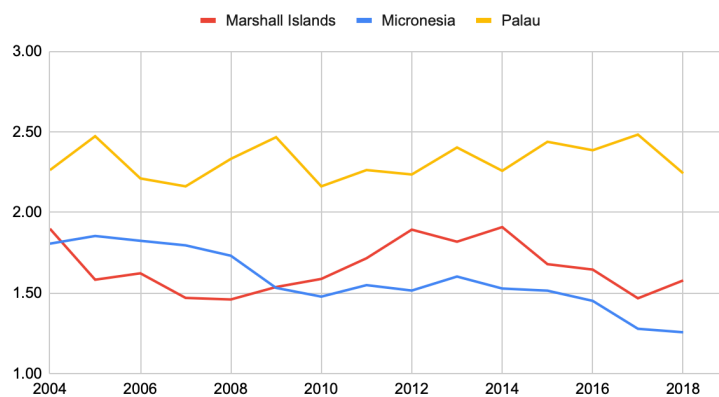
<sup>38</sup> *Ibid.*, 122–4.

<sup>39</sup> “GDP (constant 2015 US\$) - World,” *World Bank DataBank*.

“Pacific island small states,” real GDP grew by 44% during this time period.<sup>40</sup> Gross domestic product is perhaps the most straightforward indicator of economic development. According to Friberg et al. (2006), this slow and inconsistent GDP growth is a sign that the aid bureaucracy of the MIRAB economic structure is interfering with development.<sup>41</sup> Overall, the Compact has clearly not succeeded in achieving the expected transition of the FAS from lower income to higher income economies.

In addition to GDP on its own, the ratio of GDP to government revenue is useful for measuring the effect of the Compact on each of the FAS. This indicator is based on Hezel (2012)’s suggestion of the GDP to

Ratio of GDP to government revenue (Figure 2)



government expenditure ratio as a measure of development and “prospects for self-reliance” for Pacific island states. Using expenditures, Hezel obtains ratios of 1.4, 1.7, and 2.0 for the Marshall Islands, Micronesia, and Palau respectively in the year 2008.<sup>42</sup> The corresponding values obtained using government revenues are 1.5, 1.7, and 2.3; the similarity in these ratios demonstrates that government revenue is a robust substitute for expenditures when measuring the economies of these three states. Hezel offers 5.0 as a target ratio for Pacific island countries, but Figure 2 illustrates that the FAS have made no progress toward this benchmark. In fact, the ratio in the Marshall Islands and Micronesia has decreased over the data’s timeframe, showing that

<sup>40</sup> “GDP (constant 2015 US\$) - Pacific island small states,” *World Bank DataBank*.

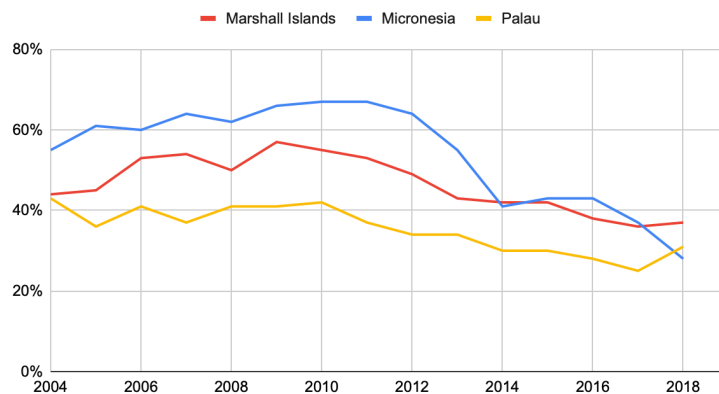
<sup>41</sup> Friberg et al., “US economic assistance,” 126.

<sup>42</sup> Hezel, “Pacific Island Nations,” 23–5.

growth in the public sector has outpaced overall GDP growth. This indicator further suggests that the Compact has failed to promote economic development and that the freely associated states have made little progress toward self-sufficiency.

Another measurement of dependency which exists in the literature is the amount of foreign aid as a percentage of total government expenditures. The International Monetary Fund calls this figure the Aid Dependency

US aid as a percentage of government revenue (Figure 3)



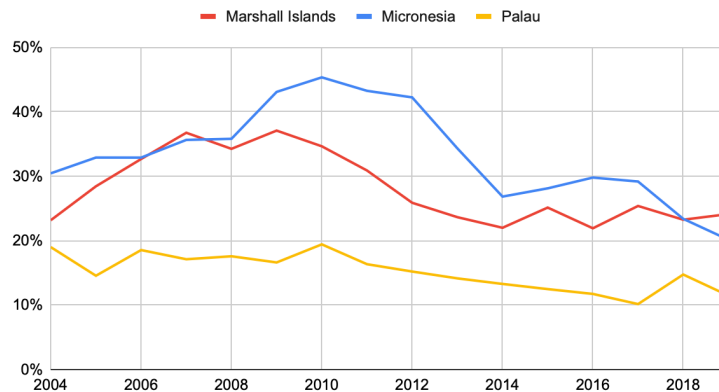
Ratio (ADR) and suggests that an ADR below 25% is desirable for developing countries.<sup>43</sup> Due to the previously discussed limitations in the data, the exact ADR cannot be obtained, but it is still possible to measure the Compact's influence on dependency by calculating the percentage of government revenue made up by Compact funding. Figure 3 depicts how this value has evolved in each of the FAS from 2004 to 2018. For all three countries, aid dependency started out around 50%, meaning that these aid grants constituted half of their governments' revenues. However, in the early 2010s this figure began to decrease, largely due to increases in tax revenue and fishing fees.<sup>44</sup> In 2018, the percentage of government revenue in Marshall Islands, Micronesia, and Palau derived from US aid was 37%, 28%, and 31%, respectively. Dependency on Compact grants has decreased, but it nonetheless remains quite high, and the FAS governments clearly still require continued assistance in order to function at their current level.

<sup>43</sup> "Figure 3.11. Aid Dependency Ratios in Sub-Saharan Africa under the Millennium Development Goals," *International Monetary Fund* (2005).

<sup>44</sup> U.S. Government Accountability Office, *Implications of Planned Ending*, 119–21.

While the previous indicator focuses on government dependency, the amount of United States aid as a percentage of GDP measures the dependency of the economy as a whole. Brazys (2010) employs this statistic in the context

US aid as a percentage of GDP (Figure 4)



of Dutch Disease in Micronesia and states that when foreign aid exceeds 20% of GDP, this aid begins to disincentivize private sector production, leading to a state of economic dependency.<sup>45</sup> The relationship between Compact funding and the GDP of the freely associated states has varied significantly between 2004 and 2019, as seen in Figure 4. Indeed, the percentage of GDP from Compact grants actually increased in the Marshall Islands and Micronesia, peaking around 2010 and decreasing since then. In 2019, this value was 24% and 20%, respectively. Meanwhile, in Palau the percentage of GDP coming from US aid was just 11%. This data indicates that the economies of the Marshall Islands and Micronesia remain dependent on US aid to the point that private sector development is discouraged. However, this dependency has clearly decreased over the last decade.

These results paint a detailed picture of the Compact of Free Association's effect on economic development in the freely associated states. Gross domestic product has increased only slightly more than the rate of inflation, and significantly less than in other Pacific island states or the world overall. The ratio of GDP to government revenue is similarly immobile, and if anything has decreased. Meanwhile, the percentage of FAS government revenue coming from

<sup>45</sup> Brazys, "Dutch Disease," 31.



US aid grants has steadily decreased since the early 2010s but is still high enough that these governments remain dependent on Compact funding. US aid as a percentage of GDP initially rose before beginning to decrease around 2010, remaining unhealthily high in the Marshall Islands and Micronesia. In sum, the data shows that the Compact has not generated substantial economic development in the FAS. These three countries, especially the Marshall Islands and Micronesia, are dependent on US grants in order to continue functioning at their current level. Nonetheless, the degree of this dependency appears to have decreased over the course of the 2010s, raising the possibility that the FAS could eventually become self-sufficient.

Based on these findings, the theory that the Compact has assisted with development in the FAS can be essentially ruled out. The data also makes the explanation that the Compact is an unsuccessful effort to achieve development more plausible than the competing theory that it is a mechanism through which the United States intentionally keeps the FAS dependent on aid in order to exploit their strategic geographic location. Indeed, while these states still require US funding to keep up their current level of government revenue, they are clearly less dependent than they once were. If the US were trying to keep the FAS reliant on Compact grants, the expected outcome would have been for the percentage of government revenue and GDP constituted by this aid to remain at a consistently high level throughout the timeframe of the data. Instead, these indicators of dependency have had an overall downward trajectory since around 2010, which strongly suggests a real effort to promote self-sufficiency.

The statements and actions of the United States government also align with the theory that the Compact was straightforwardly intended to benefit the FAS' economies. A 2001 GAO report described the Compact as having three goals: independence for the FAS, protection of the national security of all parties, and the advancement of "economic development and self-

sufficiency” in the FAS.<sup>46</sup> This report also proposed the oversight reforms which would characterize Compact II; if the US’s true goal was to maintain dependency, it would have been entirely satisfied with the status quo before Compact II, so these reforms suggest that the US had less exploitative motivations. According to a 2004 report by the Congressional Research Service (CRS), American policymakers agreed that the first two goals had been met, leaving development as the remaining objective to fulfill.<sup>47</sup> Likewise, a 2018 GAO report states that Compact aid is “intended to assist the [FAS] governments in their efforts to promote the self-sufficiency and budgetary self-reliance of their people.”<sup>48</sup> Although scholars who see the Compact as an exploitative arrangement would doubt their sincerity, the public statements of the US government indicate that development and self-sufficiency in the FAS were in fact a primary goal of the Compact.

The foregoing analysis demonstrates that the Compact of Free Association has been unsuccessful in assisting with development in the freely associated states, as argued by the third framework in the literature. Within this school of thought there is some debate as to whether the Compact’s economic goals are even attainable. Indeed, some suggest that the “conventional pathway to development” through export production is not viable for Pacific island countries,<sup>49</sup> and that self-sufficiency is “unrealistic” due to the FAS’ isolated geographic position and scarcity of natural resources to export.<sup>50</sup> The steady decrease in dependency indicators since the early 2010s suggests that this pessimistic view is not entirely warranted. In all three of the FAS,

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<sup>46</sup> U.S. General Accounting Office, *Compact of Free Association: Negotiations Should Address Aid Effectiveness and Accountability and Migrants’ Impact on U.S. Area*, GAO-02-270T (2001): 7.

<sup>47</sup> Congressional Research Service, *The Marshall Islands and Micronesia: Amendments to the Compact of Free Association with the United States*, RL31737 (2004).

<sup>48</sup> U.S. Government Accountability Office, *Compacts of Free Association: Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income*, GAO-18-415 (2018): 1.

<sup>49</sup> Hezel, “Pacific Island Nations,” 8.

<sup>50</sup> U.S. Institute of Peace, “China’s Influence,” 36.

royalties from the sale of fishing rights has emerged as a growing source of government funds, and in Micronesia and Palau the percentage of revenue obtained through domestic taxes significantly increased between 2004 and 2018.<sup>51</sup> Moreover, Palau has benefited greatly from the development of a tourism industry, which largely explains its economic outperformance of the other two FAS.<sup>52</sup> Although the Compact has not led to significant development or an end to dependency, this does not mean that these goals are inherently unachievable, and more progress could be made toward them in the future.

Development is possible in the long term, but for the more immediate future, the freely associated states remain dependent on Compact funding. The upcoming expiration of this aid in 2023 for the Marshall Islands and Micronesia and in 2024 for Palau presents a serious risk to these states' economies. Even with the trust funds which have been constructed over the last twenty years, all three countries are facing significant fiscal gaps. According to the GAO, the Marshall Islands, Micronesia, and Palau should anticipate annual budgetary shortfalls of \$40 million, \$109 million, and \$5 million respectively once grants expire.<sup>53</sup> While the situation is much less dire for Palau, the other two states are facing what the IMF calls "fiscal cliffs," which would require either severe tax increases or spending cuts for their governments to remain solvent.<sup>54</sup> As a result of their continued dependency on the United States, the FAS are vulnerable to stark economic consequences if Compact funding runs out.

Consequently, both the US and the FAS have recently taken steps to extend the Compact's economic aid provisions. The US signed memorandums of understanding with the Marshall Islands and Palau in January 2023, followed by one with Micronesia the following

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<sup>51</sup> U.S. Government Accountability Office, *Implications of Planned Ending*, 119–21.

<sup>52</sup> Finin, "Associations Freely Chosen," 189–90.

<sup>53</sup> U.S. Government Accountability Office, *Implications of Planned Ending*, 34, 58, and 81.

<sup>54</sup> *Ibid.*, 41 and 66.

month.<sup>55</sup> No formal extensions have been signed, and details about the structure of this aid are not public, but it appears that each country's Compact funding will be extended by twenty years. Media coverage of these negotiations is limited and does not address the Compact's effect on development. Instead, the renewal of aid is overwhelmingly contextualized as a part of the US's geopolitical competition with China in the Pacific.<sup>56</sup> According to the CRS, Joe Biden's budget request to Congress for fiscal year 2024 includes \$6.5 billion in Compact aid, to be delivered from 2024 through 2043. The CRS also reports that that assistance will "include greater support for environmental programs and climate change adaptation," sectors which defenders of the Compact have proposed as highly beneficial for the FAS.<sup>57</sup> However, it remains to be seen what steps will be taken to improve this funding's effect on development and solidify the early progress that has been made toward self-sufficiency.

To summarize, the Compact of Free Association is a type of treaty which the United States maintains with the Marshall Islands, Micronesia, and Palau. In exchange for authority over security and defense, the US gives the freely associated states substantial aid intended to promote development and self-sufficiency. Within the scholarship, a debate has emerged regarding the impact of this relationship on the FAS. This study finds that the Compact has been unsuccessful in helping these states achieve development. Instead, they remain dependent on the US, but the degree of this dependency is decreasing, indicating that they are capable of eventually reaching self-sufficiency. With funding about to expire, a new, renegotiated form of the Compact is expected to take effect next year. Overall, the United States' unique relationship with the

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<sup>55</sup> David Brunnstrom, "With China Looming, U.S. Signs Assistance Deal with Micronesia," Reuters, February 10, 2023.

<sup>56</sup> Matthew Lee, "US Nears New Cooperation Deals with Pacific Island Nations," Associated Press, January 14, 2023.

<sup>57</sup> Congressional Research Service, *The Compacts of Free Association*, IF12194 (2023).

Marshall Islands, Micronesia, and Palau as they work toward economic development will continue to be a key issue in the Pacific region.

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