

FEDERATED STATES OF MICRONESIA¹

The Need for Reform

The FSM faces a financial crisis that requires an immediate response. There is a need to streamline government and reduce public expenditures where possible. That however, will not be enough to respond to the financial needs of the nation over the next few years due to the magnitude of the adjustment required. A comprehensive tax reform plan is needed to raise local revenues to replace revenues no longer available under the Amended Compact.

Tax reform, however, is also needed to respond to the weaknesses of the current tax regime. There is widespread dissatisfaction with the current tax regime, both from the taxpayers and from the point of view of government. The private sector views the current tax regime as non-responsive to its needs, and a deterrent to investment.

Another problem with the current tax regime is the low level of collection. This is due to a combination of factors, including the fact that businesses owe tax even when they lose money, and also because of administrative shortcomings. The current Customs and Tax Administration is in need of substantial capacity building, both in personnel and resources, at a time when funds under the capacity-building sector grant are limited and scheduled for phase-out. Even though improvement in collection and compliance must be pursued under any scenario of tax reform, the improvement possible under the status-quo tax regime can only be marginal at best.

As a consequence tax reform in the FSM must be a comprehensive process. For an effective tax reform that is sustainable over the long term, there must be a 3-prong approach. There is a need for:

- improved tax regime
- improved tax administration, and
- increased collection and compliance

The annual decrease in Compact grants by \$800,000 which started in FY07; this decrease will continue over the life of the Amended Compact. This continual decrease alone eliminates the possibility of meeting the adjustment challenge only with reduction of government expenses. It may be possible to have a step decrease in government expenditures but it would be impossible to continually reduce the expenditures of the five FSM governments over amended Compact period.

The leadership decided at the 3d FSM Economic Summit in 2004 to adopt the Sustained Growth Strategy, which included major fiscal reform in order to improve the FSM's business environment, and promote private sector growth.

Raising revenues is not the only reason why the tax regime should be reformed. The much deeper issue is the economic structure of the FSM. The fact that the FSM public sector is too dominant in the economy, with the corollary that the private sector is weak, has long been recognized. That

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realization is one of the driving policies behind this tax reform plan. The new tax plan must assist private sector development.

The Current Situation

The current tax regime of the FSM is a reflection of its federal system. At the national level there are three national taxes: the wages and salary tax, the gross revenue tax (GRT), and import duties, each contributing about 1/3 to the total tax collection. At the state level, there are sales taxes varying from 1 percent to 5 percent, with higher excises on a number of products. There is also a form of excise tax at the national level as well, since alcohol and tobacco and a few other items are taxed at a higher rate than other imports.

The wages and salary tax is collected mainly by payroll deduction. It is levied at a rate of 6% up to \$11,000 per year and at 10 percent for income above \$11,000. Currently other forms of personal income beside wages, such as interest and dividend, or income from business investment (self-employment income for example) are not taxed.

The GRT is basically a tax on turnover (total of all business gross revenues) payable by businesses with turnover exceeding \$10,000 per year. A flat rate of \$80 is levied on businesses with turnovers under that amount. As a tax on gross revenues, the computation of tax liability does not take into consideration business expenses.

Import duties are applied to all imported goods, including those imported by government, with a few exceptions designed to promote export of fish and locally produced goods. The general rate is 4% with food at 3%, and a few goods, like alcohol and tobacco, at a higher rate.

The Constitution of the FSM allows the national government to collect import duties and income tax. The wages-and-salary and GRT are considered "income" taxes. All other forms of taxes are reserved for the states.

The states set their own sales tax rates, some using the same base as the import duty. This had led to concern from the private sector that some sales taxes are really a form of import tax. A number of other taxes are also levied, including hotel and vehicle rental taxes. Each year, state taxes constitute about 20 percent of total tax revenue. The other 80% is collected by the national government (at no cost to the states) and shared 50-50 with the states.

International donors have repeatedly pointed out that the FSM needs tax reform in light of the near-term financial requirements of the FSM.

The question is frequently asked whether the FSM can sustain an increase in tax efforts. An answer can be obtained by comparing the tax burden of the FSM and that of other Pacific island countries. At the present time, the FSM has the lowest tax-to-GDP ratio of all developing countries in the Pacific with just 11% of the size of the economy. This suggests that there is significant scope for additional revenue effort in the FSM.

Summary of Solution

The proposed tax plan of the FSM contemplates a nation-wide cooperation between national and state governments to establish a unified, country-wide tax system that would also allow some flexibility for the states. The plan comprises:

1. Elimination of the national GRT and the state sales taxes
2. Elimination of wages-and-salary tax for lower incomes
3. Introduction of a value-added tax
4. Introduction of a net profit tax
5. Creation of a single independent tax authority

As envisaged under the plan the national government will repeal its GRT statute, and amend its wages and salary law to abolish wages and salary tax on income under a certain threshold, for example \$5000. The import duties rates will be raised to match the proposed VAT rate, e.g. 10%. The VAT itself will be implemented by uniform state laws passed by the four states. The import duties will be made deductible from the VAT collected domestically, transforming import duties into the first stage of the VAT.

Under the plan the states will have some flexibility in fiscal policy because they will retain excise taxes and fees.

Is a constitutional amendment necessary?

There are two ways of implementing a VAT:

1. By constitutional amendment to the FSM Constitution, granting the national government the right to impose the tax. This is conceptually the more straightforward option. However the constitutional amendment process is costly and fraught with uncertainty.
2. What is discussed here, which requires coordinated action among national and state governments across the FSM, but no constitutional amendment. The TRTF feels this is the better option.