Chapter 7. Challenges to Achieving Economic Self-Sufficiency

7.0 Introduction

The steady decline in grant aid and conditions placed on use of funds makes it imperative for governments to increase tax revenues. At the same time, development strategies must be carefully examined to ensure that government programs efficiently address social needs and encourage meaningful private sector involvement in planning and policymaking.

7.1 Public Sector Adjustment Under Compact II

7.1.1 Development Impact of Funding Level and Terms

The impact of the steady decline in grant funding under Compact II is indicated in Table 15. Although the decline in real value of the Compact grants is in itself a source of fiscal pressure, an even more difficult problem is the conditions attached to the use of the Compact funds. Column 5 indicates the amount of government expenditures in 2005 that are deemed "ineligible" or "non-conforming" by JEMCO for use of grant funds.

Table 15. Projected Compact Grants, Domestic Revenue and Expenditure (Millions of US Dollars at 2004 Prices)

Government	2005 Compact Grants	2009 Compact Grants	2005 Domestic Revenue	2005 Ineligible Expenditure	2005 Capacity Bldg. Grant
Chuuk	29.31	27.70	5.53	8.12	3.15
Kosrae	8.41	7.94	2.42	3.85	0.90
Pohnpei	19.52	18.45	7.81	6.95	2.10
Yap	12.18	11.51	4.38	6.20	1.31
National	6.57	6.21	21.79	21.73	0.71
Total	76.00	71.81	41.92	46.85	8.17

Source: *FSM National Department of Economic Affairs, and TA No. 4258, November 2004.*

Although there is no explicit clause in the Compact agreement that prohibits grant funds from being used to pay for general government recurrent expenses, JEMCO has authority to stipulate how grant funds may be used and what conditions shall apply. Of the six sector grants provided for, the Compact clearly gives highest priority to education and health care.

As discussed previously, in negotiating the terms of Compact II, the FSM sought to include government recurrent expenditures in the Public Sector Capacity Building Grant to the extent activities contributed to enhanced government capacity and increased productivity. The US – which controls decision making with three of the five voting members – did not agree to this. However, the US did agree to a 5-year phase-in period during which capacity building grant funds could be used for non-conforming (recurrent expenditure) purposes.

As indicated in Table 15, the 2005 capacity building grant of $8.17 million represents just 10.8% of the total sector grants funding of $76.0 million. The largest sectors – those being given the highest priority by the US – are: education at $27.1 million (35.7%), health at $17.43 million (22.9%), and infrastructure at $16.9 million (22.2%). These high priority sectors, along with capacity building, take up nearly 92% of the 2005 grant funding, leaving small amounts for private sector development and the environment.

The data on state-generated domestic revenues clearly indicate that without the capacity building grant funds (column 6), only Pohnpei and the national government will be able to cover the cost of ineligible expenditures (column 5). The national government is in a much stronger revenue position, but for all the states general government recurrent expenditure (on virtually all program purposes, except education and health) will fall below what is needed unless government revenues can be increased significantly.

Technical assistance on improving and reforming tax systems in the FSM has been ongoing in recent years. The latest study, ADB TA No. 4258-FSM, *Compact Fiscal Adjustment and Transition*, provides detailed analysis and recommendations on both the transition associated with the phasing out of the capacity building grants and the urgent need for governments to increase tax revenues to accommodate the steady decline in Compact II grant funding.

Tax effort (ratio of tax revenues to GDP) in the FSM is among the lowest in the Pacific Region at 12.3% of GDP. Of seven countries, the FSM had the lowest tax effort and it was the only country with a tax effort below 17%. Three countries were above 20% and three were between 17 and 20%. The latest tax study recommended a number of options for increasing revenues, with most options necessitating substantial changes to tax administration. In options requiring lesser increases in tax burden, the states would be required to cut expenditures more deeply to accommodate the decline in Compact grant funding.

The technical assistance studies have unanimously recommended implementation of a value-added tax (VAT) to effectively raise revenue to meet both medium and long term FSM needs. The VAT would replace the customs duties and state sales taxes. A major advantage of the VAT is that it will replace two taxes that have distorting effects on the economy. The VAT is relatively simple to administer, entailing a single rate that would apply to a broad tax base including both goods and services and private and public enterprises. The VAT avoids the distortion of the sales, customs, and gross receipts tax, with their cascading effects as goods move through each level of distribution. Another major advantage is that the VAT provides positive incentives to export and investment activities, in that exported goods are exempt from this, and exporters receive refunds for VAT taxes paid on material and service inputs used to produce export goods. In the case of investment, business expenditure on capital goods is exempt from the VAT. This tax is also consistent with the requirements of international and regional trade agreements (against export subsidies vis-à-vis tax system). Another big advantage of the VAT is that it would constitute an efficient means of raising tax revenues over the long term as Compact II aid steadily declines, as the single rate could be increased. Other Pacific Island countries that have adopted the VAT include: Fiji Islands, Samoa, Vanuatu and the Cook Islands.

Effective administration of the VAT clearly calls for changes in the tax jurisdictions of the national and state governments. The recommended reform would entail a single "FSM Unified Tax Administration" (FUTA), which would be an independent agency patterned after the current FSM Social Security Administration. This agency would be empowered to collect all taxes (not just the VAT) on behalf of both national and state governments. However, each government would still maintain the authority to set the tax rates (for each category of tax, e.g., VAT, personal income tax) in its own jurisdiction. A critical issue, given the dual taxation powers of the national and state governments, is the most appropriate way to authorize and implement a VAT. Two approaches are suggested: (1) the national government will enact legislation for a VAT on imports, and it will be left to the States to enact associated legislation for a VAT on domestic production; and (2) the states will endorse VAT without the national government taking any action on the premise that even though the VAT would be collected on imports (a national tax power) it would subsequently be rebated. In view of possible legal complications in interpreting constitutional jurisdiction on States levying VAT on imports, the first approach may be preferable but would be administratively more complicated to implement.

While the VAT would be the best long-term solution for the need to increase tax revenues, in the short term there will be a need for the state governments to raise existing taxes, and cut recurrent expenditures.

Box 10. Revenue Sharing Betweem the State and National Governments

The FSM Constitution specifies that the taxes collected by the national government – on imports, fuel, wages and salaries, and business receipts – be divided between the national government and the states in which they are collected. The division of the Compact transfers in Compact I was established by a memorandum of understanding worked out between representatives of the different governments.

The level of fisheries revenue, primarily from agreements with distant water fishing nations, increased sharply during the late 1990s. This led to an effort by the states to have these funds be divided in the same way as the tax revenues. This attempt was unsuccessful, as the courts ruled in favor of the national government. Nevertheless, the FSM Congress agreed to increase the states' share in tax revenue, with the proviso that the additional funding be used for capital expenditure in the areas of health and education.

Compact Distribution Formulas

	Chuuk	Kosrae	Pohnpei	Yap	National
FY 2004	36.00%	10.80%	24.10%	15.80%	13.30%
FY 2005	38.57%	11.06%	25.69%	16.03%	8.65%

More recently, the states have pushed for a change in the distribution formula for Compact revenues, which would reduce the share going to the national government. Partially in response to this move, the FSM Congress withdrew the additional amount of revenue sharing from tax revenues, returning to the amounts required by the Constitution. The end result was that the States ended up with a larger share in Compact revenues, which are subject to significant restrictions, while losing access to domestically generated tax revenues.

The applicability of the revised distribution formula for Compact revenues has been called into question, effectively reopening the dialogue in that area. The FSM Congress approved the change in the distribution formula for FY 2005, but reserved the right to make adjustments in future years. It is clear that there will be a need for continued dialogue on issues related to revenue sharing.

7.1.2 Medium Term Policy Adjustments

In view of the restrictive terms on use of funds and the steady decline over time in grant funding, Compact II will place an increased burden on the management capacity of the FSM governments. Preparing the consolidated funding proposals and keeping up with required reporting for the five governments will be a significant challenge. Several proposals have been prepared for a restructuring of government services in order to better deal with these requirements, but none have been adopted.

In adjusting to the reduced level of annual grant funding, FSM governments in the short to medium term will have to increase tax revenues and raise efficiency in the provision of services. Service cutbacks in the short-term are also probably unavoidable.

Short-term tax revenue raising options being considered include the following:

- *Import duties in the FSM are generally low by regional standards. Several types of commodities enjoy a significant level of tariff protection, including bar laundry soap and fruit juices. The protected industries have difficulty in meeting local demand, so that there is some support for the removal of this protection. It seems likely that the initial target for revenue increases would be import surtaxes on tobacco and alcohol. Reduced consumption of alcohol and tobacco as a result of increased taxes would also be expected to have positive economic consequences, through health and social impacts (i.e., lowering healthcare and social services costs).*
- *The use of the GRT as a substitute for a business earnings tax leads to significant distortions due to differences in the effective rate for different industries and businesses. It would be preferable to replace the current GRT with a less distortionary alternative, such as a corporate income tax. It would appear that a revenue-neutral profit tax in the range of 20 per cent could be a feasible option, since this rate would be at the low end of the rates currently applied in other countries in the region.*
- *The Wages and Salaries Tax is only mildly progressive, with a significant discontinuity at the $5,000 level on annual income. The top rate of 10% is quite low by regional standards. A revised structure, involving additional brackets and higher rates, could increase collections and make the overall tax system more progressive.*

Constitutional restrictions on the taxes that can be collected by the different levels of government complicate any attempt to increase revenues. This is particularly true for the potential implementation of excise taxes or the VAT. The national government has the right to levy import and income taxes, the proceeds of which are shared with the states. Income taxes include a Wages and Salaries Tax that applies to individuals and a Gross Receipts Tax that applies to businesses. Other taxes – including sales and other consumption-based taxes – are reserved for the states. There is considerable variation in the tax effort at the state level. Overall, however, state level taxes account for only about 20% of total tax revenues.

A further complication is introduced with the continued application of the revised distribution formula of the Compact grants (Box 10). It is probable that there will be further dialogue between the two levels of government regarding the distribution of Compact grants and the formula for revenue sharing. This dialogue could be a useful opportunity for discussing other issues related to taxation, such as the potential for coordinating efforts to improving collections.

7.2 Policies and Strategies for Achieving Sustainable Growth

In the medium term, the reduced level of Compact transfers can be expected to have a negative impact on overall economic growth. The series of annual reductions in grant assistance, in favor of increased contributions to the trust fund, can also be expected to have a similar impact.

In the short to medium term, private sector activity in the FSM is likely to continue to be dominated by services – including retail sales – aimed at the local market. Retail activities may become increasingly competitive, and some consolidation is possible as real incomes (and consumer spending) fall in the short term under the pressure of likely public sector expenditure cuts.

Import substitution, particularly in terms of local substitutes for imported produce, could become more important. Imported produce is expensive and often of poor quality due to shipping time and costs. Falling real incomes – heavily affected by necessary public sector wage restraint and other recurrent expenditure cuts in conjunction with price level inflation – may make agricultural self-employment a more attractive option for those with access to land.

Distance from markets and high labor costs will continue to work against the development of export-oriented manufacturing. Changes in the world trading system, including the development of regional trade agreements to which the US is a party, are also expected to reduce or eliminate former incentives in the freely associated countries for activities such as garment manufacturing and fish processing plants.

The terms of the original Compact I agreement were intended to provide the FSM with unusually favorable access to US markets. These benefits have lost value over time, as other countries also tapped into US markets through regional trade arrangements. Broader changes in the world trading system have also reduced the value of the provisions in the original agreement. In the course of the Compact II negotiations, the FSM expressed an interest in exploring arrangements similar to those under regional trade agreements between the US and other nations. In the end, however, the outcome was limited to an updating of the original terms.

Several elements of an overall development strategy have been suggested in previous sections. These include:

- *Reform of the FSM governments tax systems. This includes implementation of a unified tax administration system and VAT to replace customs and sales taxes;*
- *Raising efficiency of public service. This involves increased HRD, comprehensive review of departmental and agency missions, functions and job position requirements, wage rates, and performance incentives;*
- *Accelerated movement towards rationalization of the PSE sector. This will demonstrate a firm commitment to the principal of encouraging private sector performance of commercial activities and non-competition of public enterprises with private businesses in providing goods and services;*
- *Pro-active policy of encouraging growth of the private sector including non-profit organizations. This should include policy elements focused on gradually reducing wage rate differentials between public and private sector employees, implementing a tax system which provides incentives for investment, exports and equal treatment of PSEs and private businesses, and contracting out services that can be provided more efficiently by the private sector;*
- *Public sector provision of critical support services. Among these are agricultural extension, industry/sector price and production statistics, credit and loan financing accessible to small and micro businesses, institutional mechanisms enabling businesses and non-profits to participate in planning and policymaking at national and sectoral level, and support in working with private sector to jointly provide entrepreneurial and business skill training;*
- *Accelerated movement towards providing the critical elements of a PSD enabling environment. This entails transparent and efficiently administered foreign investment regulations, legal-regulatory regime that enables efficient equitable access to land, secure transactions and other commercial legislation designed to lower risk and cost of doing business, and legal/regulatory mechanisms enabling mortgage or other land-secured loan financing.*

Implementing some of these strategies will require specific support actions on the part of JEMCO to increase the likelihood of success, and reduce the time required for implementation. There needs to be explicit agreement on use of Compact II grant funding for private sector targeted training, industry information/ technical support, facilitation of the transformation of PSE activities to private sector operations, and contracting of legal/technical expertise to assist achievement of specific elements (objectives) of private sector enabling environment. Together with this, it is necessary to preclude government use of funds for recurrent costs.

In conjunction with human resource development, there is a legitimate need for project/program funding that should come via the capacity building sector grant. If tied to specific project designs, this would constitute a use of funding consistent with the goals and objectives of Compact II.

7.3 Out-Migration

Out-migration has increased significantly since 1997 and the FSM needs to take a close look at this phenomenon in terms of its extent and likely consequences. Certainly more information and analysis will be needed to enable the formulation of policy options. What is apparent is that continuing poor economic performance in terms of job creation and maintaining household incomes in the face of inflation will result in continued heavy out-migration of FSM citizens.

There were over 9,100 FSM citizens living in the CNMI, Guam, and Hawaii in 1997 according to US Bureau of the Census survey data. This number refers to the Compact "impact" population – those who emigrated from the FSM after 1986. The US Census Bureau conducted an update survey in the same areas in 2003. For the "impact" population in 2003, the number of migrants included children of the post-1986 emigrants under the age of 18. This latter survey indicated an FSM migrant "impact" population of 15,514, an increase of about 6,400 or 70%.

This number will be significantly higher if total migrants – including those who emigrated to the US mainland and children above18 – are taken into account. Estimates have been made based on adjusting the intercensal population growth rates for declining fertility rates. Data from the FSM 2000 National Census Report indicates that the decline in fertility rates was most pronounced from 1980-1990. Utilizing data on both Age Specific Fertility Rates and Crude Birth Rate for relevant periods between 1980 and 2000, a low (2.12%) and a high (2.58%) adjusted population growth rate was estimated for the purpose of projecting total FSM population growth between 1989 and 2003. These rates are of course mere approximations. Resulting projections of total FSM population (both resident in FSM and all citizens living outside the FSM) for the year 2003 would be between 128,400 and 136,800. Given that the estimated 2003 resident FSM population is 107,800, this means that between 20,600 and 29,000 FSM citizens are estimated to be living overseas – between 16 and 21% of the total FSM population. Most of the overseas citizen population would be in the CNMI, Guam, Hawaii and US mainland.

Differences in social and economic characteristics of the Compact "impact" population and the FSM resident population are highlighted in the box below. The comparisons are based on the US Census survey data and the FSM 2000 Census. Not covered in the box is the place of residence of impact area migrants in 1993, 10 years before the survey was taken. Of the impact area population 10 years of age and older in 2003 (11,292), 50.5% (5,702) had lived in the FSM in 1993, and of this number, 68.6% (3,911) were from Chuuk. Of the total number who were resident in Chuuk State in 1993 (2,751), a majority lived in islands outside of Weno, the State center.

The migrant population in the US impact areas had a higher labor force participation rate – 58% (of those age 16 and older) versus 44% (of those 15 and older) for the FSM resident population. In terms of economically active people in relation to working age, 49% of the migrant population was economically active (either in formal employment, self-employment or, in family businesses) versus 37% in the FSM. In the FSM, the economically active includes those in subsistence livelihood in addition to those in formal and informal wage employment. With respect to the number of unemployed people, 9.0% were unemployed in the migrant population – a higher rate than the 7.1% in FSM. These are not comparable to unemployment rates reported in most industrial countries, which are based on the number of persons in the labor force without any work and who are available to work and are actively looking for work. Availability of subsistence work in the FSM (but essentially not available in the US impact areas) makes comparisons of *unemployment*, even in terms of working age population, difficult between the two populations since most FSM residents could be working in subsistence activities even if this were only part-time in nature. Having said this, the formal unemployment rate for migrants in the impact areas is quite high, 15.5% in 2002. This high rate may reflect the reality that FSM citizens are not as competitive in the labor market as FSM residents who have been trained in the US, even in the CNMI and Guam.

Migration has been an important part of the FSM-US relationship since the beginning of Compact I. The right to live and work in the US and its territories

Box 11. Socioeconomic Differences Between FSM Residents and Out-migrants in US[1]

- In the 20-39 age group, there is a significantly larger percentage of both males and females (39.1 and 38.4%, respectively) in the out-migrant population, compared with the FSM resident population (27.1 and 28.3%, respectively).
- With respect to educational attainment of persons aged 25+, 53.6% of migrants had a high school diploma or at least some level of high school attainment, compared with 32.3% of FSM residents. 18.8% of migrants compared with 14.8% of FSM residents attained an AA or AS college degree or some college. Only in terms of bachelors degree or higher degree did FSM residents have higher attainment (3.6% compared with 1.8% of migrants). The latter figures for higher educational achievement are not surprising, given that the majority of FSM citizens seeking a bachelors or higher degree probably go to a mainland US institution. But data for the US mainland migrants are not available.
- In terms of income, median household income in 2002 for out-migrants was $21,317, compared with 1999 household median income of $4,618 for FSM residents. For individuals age 25 and over, the median income of out-migrant population in 2002 was $11,041 for males and $8,928 for females. For FSM residents, the median income for males age 25 and over was $2,044 in 1999, and for females it was $918. With respect to out-migrant households with public assistance income, 414 households (14.6% of all households) received assistance in 2002 and the mean amount of assistance per household was $161. Given the mean amount, it seems evident that most migrant households receiving public assistance typically did so for a relatively short period of time. There is no comparable data for FSM residents. However, in 1999 there were 2,437 persons receiving income from social security, pension or retirement, and median income from this source was $1,848. In terms of remittances, 74 impact area out-migrant households (2.6% of total households) received such income and median amount received was $3,747. For FSM residents, 5,837 persons reported receiving remittances from outside of the FSM and the median amount of such income was $565.
- In terms of reason for out-migration, of those born outside the impact area, the main reason given was employment (33.2%). Second largest reason category was, dependent of employed person (23.9%). None of the other reasons given accounted for more than a 6.8% share of the reasons, but a large number surveyed gave no reason (25.7%).

Note: 1 – Characteristics are for those migrants in CNMI, Guam, and Hawaii only, based on the 2003 surveys, compared with FSM residents surveyed in 2000 Census. Data are not available for FSM citizens living in US Mainland.

was seen as an important "safety valve", allowing Micronesians to seek employment there in the event that adequate opportunities were not available at home. There has been a substantial flow of migrants throughout the Compact period, primarily towards Guam and Hawaii, but in the early years migration was often temporary. Since the second step-down of US grant aid in 1997, the volume of migration has increased substantially, and increasing numbers of migrants are moving beyond Guam and Hawaii to the US mainland. With larger numbers of better-educated citizens moving abroad, remittances could become an increasingly important source of income for the FSM economy.

Further survey and research work will be needed to determine whether remittances are likely to become an important source of transfer income, or whether they will not be a factor if FSM households in the US become less involved with their families in the FSM.

Eventually, at least some portion of the out-migrant population will return to the FSM. To the extent that they bring new ideas and skills, they may help boost entrepreneurial activity in the economy. This could also help address human resource constraints with respect to the provision of government services.

7.4 Self-Sufficiency by 2023: Attainable Goal?

The high-growth or sustained growth strategy endorsed by the Third Economic Summit relies mainly on tourism. The tourism sector has substantial potential, but all the elements needed to stimulate significant growth will require a strong commitment to the policies recommended by this report, the same policy recommendations made by a host of technical assistance missions in the last decade. Even with the new commitment called for by the Third Economic Summit, there will be a time-lag factor in that many policy initiatives need two years or more to be fully implemented (e.g., tax reform, comprehensive training and institutional strengthening of the public service).

Another major medium-term constraint is likely to be the adequacy of infrastructure investment, particularly those needed to support a major campaign to make tourism the leading economic sector. Given the realities of Compact II conditions, there will be an inadequate level of funding for key infrastructure needed to support rapid growth in tourism.

Another major concern is whether the general public will accept and support a major expansion in tourism. As acknowledged in the SDP's tourism sector plan, a major education and awareness program will have to be undertaken.

Better economic performance in the agriculture and fisheries sectors will require sufficient resources to implement the recommended policy initiatives. However, given the fiscal expenditures compression that must be borne by FSM governments in the mid-term, there will unlikely be any available resources to support PSD. With demonstrated commitment of FSM governments to policy reforms, adjustments in JEMCO policies on sector grant use conditions would be warranted. This would at least partially address the economic and financial capacity constraints that will have to be overcome if sustained growth is to be achieved and progress made in becoming more self-sufficient by 2023.

The Compact II trust fund will provide a sustainable, relatively stable source of funding for government operations. The performance of the fund, over the twenty years covered by the amended Compact, can be expected to have a positive longer-term impact on investor confidence, as will any indication that the US will continue to provide additional economic assistance beyond 2023.

There has been a succession of ADB-supported resident economic advisors, with significant continuity in terms of personnel, over a period of nearly nine years. The primary functions of the economic advisors in the FSM remained largely the same. However, a gradual shift in emphasis of duties has occurred, from acting in an advisory capacity to becoming more involved in line management responsibilities. The EMPAT team and successor activities have essentially filled the role of government personnel that would normally have been responsible for economic management. An example of one such activity has been technical assistance provided by advisors acting in the capacity of linking the FSM and the donor community on issues related to economic management.

Capacity building in economic planning and statistics in the national government has been limited in both scope and effectiveness. Rather than working with mid-level counterparts, the focus has been on recruiting trainees who essentially serve as junior-level members of departmental planning and statistics divisions. To the extent that ongoing substantive training would have been given in conjunction with the assignment of increasing responsibilities and commensurate wage increases, the limited capacity building would probably have had a more permanent beneficial impact. The experience has been that most of the junior citizens who received graduate level training have left government service.

In the FSM the three main productive sectors – agriculture, fisheries, and tourism – have the largest potential for generating income and jobs. From these sectors they could generate the export and import substitute income necessary to narrow the existing large gap in merchandise trade and in the overall current account imbalance.

The lead-up to the Third Economic Summit included a Strategic Development Plan (SDP) for the tourism sector. The tourism SDP was valuable in informing summit participants, and enabled the Third Summit Tourism Committee to produce a Tourism Strategic Planning Matrix (SPM) based on a current sector assessment. The same cannot be said for the agriculture and fisheries sectors. The Third Summit did produce SPMs for these sectors, but without the benefit of current SDPs.

One may question the basis for including these sector study findings and recommendations along with other emerging economic issues. However, sector performance in both agriculture and fisheries in recent years has been poor relative to the early 1990s, and many of the constraints to better performance could be overcome. Given these circumstances, agriculture and fisheries performance constitute emerging issues. The tourism sector also has not performed well, and it must do much better if sustained growth of income and employment is to be achieved and the FSM is to make any progress in becoming more self-reliant.

The poor performance of tourism may be explained in large part by the same lack of commitment on policy reforms that has affected the performance of agriculture. Although the FSM Strategic Development Plan that was submitted to Congress for approval in January 2005 assumes agriculture and fisheries would also contribute to sustainable economic growth, the SPD clearly expects tourism to be the principal driver.

Chapter 11 covers other emerging economic issues that must be addressed by the FSM if it is to achieve its Millennium Development Goals (MDGs) by 2015 and significantly raise economic self-sufficiency by the end of Compact II. These emerging economic issues include out-migration, capacity and productivity of the public sector, increased hardship, and governance standards.