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GAO

Report to Congressional Committees

February 2000

NORTHERN MARIANA ISLANDS

Garment and Tourist Industries Play a Dominant Role in the Commonwealth's Economy

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Abbreviations

ACIR	Advisory Commission on Intergovernmental Relations
CNMI	Commonwealth of the Northern Mariana Islands
FSM	Federated States of Micronesia
GAO	General Accounting Office
GDP	Gross domestic product
IMF	International Monetary Fund
OMB	Office of Management and Budget
RTS	Representative Tax System
WTO	World Trade Organization

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United States General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-284271

February 14, 2000

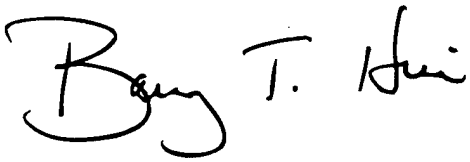
The Honorable Slade Gorton
Chairman
The Honorable Robert C. Byrd
Ranking Minority Member
Subcommittee on Interior and Related Agencies
Committee on Appropriations
United States Senate

The Honorable Ralph Regula
Chairman
The Honorable Norm Dicks
Ranking Minority Member
Subcommittee on Interior and Related Agencies
Committee on Appropriations
House of Representatives

As directed in Conference Report 105-825, we are reporting on the state of the economy of the Commonwealth of the Northern Mariana Islands and its revenue-raising efforts. More specifically, the report discusses the impact of the garment and tourist industries and foreign workers on the Commonwealth's economy. It also discusses how the revenue-raising efforts of the Commonwealth compare with those of other U.S. territories and Freely Associated States and how the taxes and fees paid by the Commonwealth's garment industry compare with those paid by the garment industry in the United States.

We will send copies of this report to the Honorable Bruce Babbit, Secretary of the Interior; Ferdinand Aranza, Director, Office of Insular Affairs; and the Honorable Pedro P. Tenorio, Governor, Commonwealth of the Northern Mariana Islands.

Please contact me at (202) 512-3841 if you or your staff have any questions. Additional contacts and key contributors to this report are listed in appendix V.



Barry T. Hill
Associate Director, Energy,
Resources, and Science Issues

Executive Summary

Purpose

The Commonwealth of the Northern Mariana Islands (CNMI) is a U.S. territory with commonwealth status in the western Pacific. The Covenant establishing the CNMI places it under U.S. sovereignty and provides for U.S. citizenship for people born there, yet pledges self-government for local affairs. The Covenant also allows the CNMI to control its own immigration policy and to set its own minimum wage, which, at $3.05 per hour, is substantially below the minimum wage in the United States of $5.15 per hour (the CNMI is currently reviewing its minimum wage rate). Businesses in the CNMI, particularly in the garment and tourist industries, employ many foreign workers who have work permits that do not lead to citizenship. To obtain more information on the economy of the CNMI, the Congress directed GAO in the conference report accompanying the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 to complete analyses and reports concerning the CNMI. Following discussions with the offices of the responsible congressional committees, GAO has addressed the following questions:

1. What has been the impact of the garment and tourist industries and the use of foreign workers on the economy of the CNMI?

2. How do the revenue-raising efforts of the CNMI and the payments that the CNMI receives from the U.S. Treasury compare with those of other U.S. territories and Freely Associated States?[1]

3. How do the taxes and fees paid by the garment industry in the CNMI, expressed as a percentage of gross receipts, compare with the taxes and fees paid by the garment industry in the United States?

As agreed with the offices of the Subcommittees on Interior and Related Agencies of the House and Senate Committees on Appropriations, GAO did not assess the issue of compliance with labor and worker safety laws in the CNMI in this report. Nor did GAO assess the sociological and political ramifications of the presence in the CNMI of a large population of noncitizens. While GAO gathered information on the effects of the current

[1]The Republic of the Marshall Islands, the Federated States of Micronesia, and the Republic of Palau, former components of the Trust Territory of the Pacific Islands, are sovereign nations that have compacts of association with the United States and are generally called the Freely Associated States. The Freely Associated States and the other U.S. territories (the Commonwealth of Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam) are sometimes referred to collectively as outlying areas, a term that GAO uses in this report.

minimum wage and immigration policies in the CNMI on the garment and tourist industries, it did not assess whether changes are needed in those policies.

Background

The Northern Mariana Islands are a group of 14 islands in the Pacific Ocean, lying just north of Guam. They are located about 3,200 miles west of Honolulu, 5,500 miles west of Los Angeles, and 1,500 miles south of Tokyo. The United States took control of the Northern Mariana Islands from Japan during the latter part of World War II. In 1947, the U.S. Congress approved the Trusteeship Agreement that made the United States responsible to the United Nations for the administration of the islands. Accordingly, the United States was obligated to promote the political, economic, social, and educational advancement of the Islands' inhabitants leading to self-government or independence. For about the next 15 years, the Northern Mariana Islands had little economic development. Except for some U.S. military activity on the Islands, the economy consisted of subsistence farming and fishing, small-scale manufacturing, and trading. Later, the Northern Mariana Islands sought self-government and permanent ties to the United States. Over time, the Islands negotiated different political arrangements with the United States. In March 1976, the President signed Public Law 94-241, which formed a Covenant to Establish a Commonwealth in Political Union With the United States of America. A basic objective of the Covenant was to encourage economic growth and a standard of living in the CNMI comparable to that in the United States.

The CNMI has used its authority to control its own immigration policy to bring in foreign workers, mostly from China and the Philippines–under temporary, but renewable, work permits that do not lead to citizenship–and to allow the entry of foreign business owners and their families. In large part because of the influx of these foreign workers and entrepreneurs, the population of the CNMI has grown rapidly, increasing from about 16,800 in 1980 to 79,000 in 1999.[2] On Saipan–the island that is the capital of the CNMI and its main population center–foreign workers and other non-U.S. citizens

[2]The 1999 figure of 79,000 is an estimate based on census figures in 1995 and the growth rate of the population between 1990 and 1995. According to the CNMI Governor's Office, immigration data, school enrollment, hospital records, nonrenewals of business licenses, and other sources all indicate that there are fewer people.

constitute about 58 percent of the population at present.[3] Businesses in the CNMI can also sell some goods to buyers in the United States duty-free and are not subject to import quotas for goods sold to the United States. In particular, as long as certain conditions are met, garments manufactured in the CNMI can be sold to buyers in the United States without incurring import tariffs, and there is no quota on imports of garments to the United States from the CNMI. In addition, these garments can bear labels identifying them as having been made in the United States. These features give garment manufacturers in the CNMI greater access to the U.S. market than is available to garment manufacturers from outside the United States. The garment industry has grown rapidly in the CNMI and is, along with the tourist industry, one of the two largest sectors of the economy. Nearly all garments manufactured in the CNMI are exported to the United States. Median household income for the largest indigenous group of people in the CNMI (the Chamorros) rose from about $8,900 in 1980 to $30,700 in 1999.[4] The CNMI government relies on revenue derived locally (taxes, fees, charges, etc.) and on payments from the U.S. Treasury. The Covenant allowed the CNMI to establish its own tax and fee structure. Garment manufacturers in the CNMI presently pay the government a user fee equal to 3.7 percent of the gross value of their exports to the United States and a tax of up to 5 percent on the gross receipts from sales they make in the CNMI. They also pay fees to the government for each nonresident they employ. In contrast, garment manufacturers in the United States typically pay income taxes (sometimes state and local, as well as federal) and property taxes. They may also pay sales taxes.

Results in Brief

The garment and tourist industries contribute directly to the CNMI economy by creating jobs and producing goods and services for export. They also contribute indirectly to the economy through purchases of local

[3]Saipan is the CNMI's commercial and government center and accounts for about 90 percent of the population of the CNMI. Some of the non-U.S. citizens on Saipan are citizens of the Freely Associated States and are considered local residents in this report. According to the CNMI, in 1999, 1,495 of the non-U.S. citizens were the immediate relations of U.S. citizens.

[4]GAO did not calculate the change in income in constant, or inflation-adjusted, dollars because it was unable to find a consumer price index for the CNMI that went back to 1980. Even if such an index had been available, there would have been problems with using it because the types of goods and services purchased in the CNMI—the consumer's so-called market basket—changed so much over this period. Therefore, measuring the change in the price level of a fixed market basket of goods and services would not have accurately measured the change in the cost of living.

goods and services and with taxes and fees paid to the government. The garment and tourist industries account–directly or indirectly–for about 80 percent of the employment in the CNMI and for over 90 percent of the economy's exports, according to an October 1999 economic study of the CNMI prepared under the direction of the Northern Marianas College with funding from the Department of the Interior that GAO reviewed and found reasonable. These industries also contribute to the government's total revenue. For example, in 1998, the garment industry directly contributed about $52 million, or 22 percent, of the government's $234 million budget. In 1997–the latest date for which data on visitor expenditures are available–the tourist industry contributed at least $34 million, or 14 percent, of that year's budget of $248 million. The garment and tourist industries and the workers that they employ also require government spending for services and infrastructure, but GAO questions the conclusion of a January 1999 study commissioned by the Department of the Interior that this spending exceeds the industries' revenue contributions.

The garment and tourist industries are dependent on foreign workers for much of their workforce because the labor pool of local residents, even including those currently unemployed, is insufficient to support an economy of the size and scope that exists in the CNMI. For example, on Saipan–the most populated island in the CNMI and its business center–the current labor force of local residents contains only about 12,800 people, including U.S. citizens not born in the CNMI and non-U.S. citizens from the Freely Associated States who have the right of residency and employment in the CNMI. However, the economy of Saipan employs about 43,700 people. All sectors of the economy, including the government sector, hire foreign workers. In addition, foreigners own and operate businesses in the CNMI. The economy of the CNMI is vulnerable to outside events because of its heavy reliance on only two industries, which may be affected by changes in Asian economic conditions, legislation in the United States, or international trade agreements. For example, changes that reduced or eliminated the advantages of manufacturing garments in the CNMI might cause some or all of the CNMI garment industry to relocate to other countries, causing job losses among local residents and revenue losses to the CNMI government.

The CNMI is more self-sufficient fiscally than other outlying areas, such as Guam, Puerto Rico, the U.S. Virgin Islands, and the Freely Associated States. Between 1994 and 1997, about 87 percent of the CNMI government's general revenue came from local sources rather than from payments from the U.S. Treasury. The ratio of locally derived government revenue to gross

domestic product (GDP) in the CNMI is also higher than that of most other outlying areas and is larger than the comparable ratio for all levels of government in the United States.

Using data on the major taxes and fees, GAO found that for the period 1993 through 1998, the taxes and fees paid by the businesses in the CNMI garment industry represented about 5.0 percent of their gross receipts, while for the period 1991 through 1996, the taxes and fees paid by the businesses in the U.S. garment industry represented about 3.3 percent of their gross receipts. However, the owners of those businesses may not ultimately bear the full economic burden of the taxes and fees that they pay. Some of the burden may be shifted to consumers, workers, and investors in other industries, but the extent of this shifting is unknown.

Principal Findings

The Garment and Tourist Industries Are the Driving Forces of the CNMI Economy

The economy of the CNMI relies on the garment and tourist sectors for most of its employment, exports, and production. Both industries contribute directly to the economy by generating employment and bringing in revenue from outside the CNMI via exports. For example, in 1999, the garment industry directly employed about 16,000 workers, including 13,500 foreign workers and 2,500 local residents. The tourist industry, in 1995, directly employed about 9,600 workers, including 6,900 foreign workers and 2,700 local residents. According to an October 1999 economic study that GAO reviewed and found reasonable, these two industries produced about 96 percent of the CNMI's exports and were responsible for about 85 percent of the CNMI's total economic activity.[5]

[5] *An Economic Study for the Commonwealth of the Northern Mariana Islands,* Business Development Center, Northern Marianas College, with funding provided by the Office of Insular Affairs, U.S. Department of the Interior, Oct. 1999.

The rapid growth of the CNMI's garment and tourist industries during the past two decades has contributed to the development of other businesses and the growth of the government sector. These industries are linked to the rest of the economy through the purchases of goods and services from other industries, tax revenue paid to the government, and workers' spending. In addition, these industries and their workers create a need for increased government spending. A January 1999 study commissioned by the Department of the Interior concluded that the garment and tourist industries and the workers they employ require government spending for services and infrastructure that exceeds what they contribute in revenue.[6] However, because that study had a number of methodological weaknesses (in particular, understating the contributions made by the garment and tourist industries to the economy and overstating the industries' impact on government spending), GAO believes that this conclusion is questionable.

Currently, the CNMI's tourist industry is in a slump caused by the Asian economic crisis of 1998 and 1999. The number of visitors to the CNMI declined by more than 30 percent between 1997 and 1999, which has caused some businesses to close and others to lay off workers. In contrast, the garment industry, which sells primarily to the U.S. market, has grown since 1997, partially insulating the economy of the CNMI from the Asian downturn. Nonetheless, the economy is worse off today than it was in 1997, and government revenue was about $32 million lower in 1999 than in 1997, a reduction of about 13 percent.

The labor pool of local residents, even including those currently unemployed, is insufficient to provide labor for the CNMI economy. In 1999, the total size of the resident workforce on Saipan was only about 12,800,[7] while the economy of Saipan employed about 43,700. As a result, both the garment and tourist industries are heavily dependent on foreign workers. For example, in 1999, foreign workers constituted about 84 percent of the garment industry's workforce of 16,000. All sectors, including the government, employ foreign workers because they require

[6] *CNMI Fiscal Impact Report: The Impact of Non-Residents on the Economy and Public Infrastructure of the Commonwealth of the Northern Mariana Islands,* prepared for the Office of Insular Affairs, U.S. Department of the Interior, by Robert W. Rudolph and James C. Nicholas, Jan. 1999.

[7] This group includes, in addition to U.S. citizens born in the CNMI, U.S. citizens from Guam and elsewhere (including the U.S. mainland) and those non-U.S. citizens born in the Freely Associated States who have the right of residency and employment in the CNMI.

workers with skills not available in sufficient supply among the resident workforce. Foreigners also contribute entrepreneurial skills and capital to start businesses, and many businesses in the CNMI are owned by non-U.S. citizens.

Because of its reliance on only two large industries and on foreign workers, the economy of the CNMI is vulnerable to events that affect these industries or the terms under which foreign workers may enter and work in the CNMI. A tourist industry revival, which would have a positive effect on the overall economy, depends on continued improvement in the economies of Asian countries. If changes in international trade agreements or legislative action reduced or eliminated the tariff, quota, and labeling advantages of manufacturing garments in the CNMI, some or all of the CNMI garment industry might relocate to countries with lower wages.[8] Such relocation could cause local residents to lose their jobs and the CNMI government to lose tax revenue. Major changes in the availability of foreign workers or in their terms of employment would also have a large impact on the economy because of the importance of foreign workers in all sectors.[9]

The CNMI Is More Self-Sufficient Fiscally Than Other Outlying Areas

In recent years, the government of the CNMI has relied for its revenue on local sources–taxes, licenses, fees, and other charges–to a greater extent than have other outlying areas, such as Guam, Puerto Rico, the U.S. Virgin Islands, and the Freely Associated States. Between 1994 and 1997, the CNMI government obtained about 87 percent of its general revenue from local sources, while payments from the U.S. Treasury accounted for about 13 percent. During this period, other outlying areas obtained more of their general revenue from federal contributions and less from local sources. Taxes were the predominant source of the CNMI's local revenue during this period, accounting for about 70 percent of local revenue. The largest source of tax revenue in the CNMI was the business gross receipts tax, which accounted for about 37 percent of total tax revenue.

[8]These advantages include tariff-free and quota-free access to the U.S. market and the ability to identify the garments as having been made in the United States. Even if tariffs and quotas were completely eliminated, the additional advantage that garments manufactured in the CNMI can bear labels identifying them as having been made in the United States would remain.

[9]Two bills introduced into the 106th Congress, H.R. 730 and S. 1052, could make it harder for foreign workers to work in the CNMI.

GAO estimated that the CNMI's ratio of government revenue derived locally to GDP was between 29 and 45 percent in the period 1994 through 1997, which was higher than the ratio for most other outlying areas. This ratio, which expresses the fraction of the overall level of economic activity or taxable capacity used to finance the government sector, is often used to measure a country's tax effort. GAO provided range estimates for this ratio for the CNMI and other outlying areas because the GDP data necessary for more precise estimates were unavailable. The ratio of local revenue to GDP in the CNMI was also higher than that for the United States (federal, state, and local governments combined), which was 28 percent in 1996.

Data Suggest That the Garment Industry in the CNMI Pays a Higher Share of Its Gross Receipts as Taxes and Fees Than the Garment Industry in the United States

Available data suggest that the taxes and fees paid by the garment industry in the CNMI represent a higher share of the industry's gross receipts than do the taxes and fees paid by the garment industry in the United States.[10] GAO used data on the major taxes and fees paid and found that from 1993 through 1998, the taxes and fees paid by the garment industry in the CNMI represented about 5.0 percent of its gross receipts, while from 1991 through 1996,[11] the taxes and fees paid by the garment industry in the United States represented about 3.3 percent of its gross receipts.

While remaining legally responsible for paying a tax or fee, garment manufacturers, like other businesses subject to taxation, may be able to shift some or all of the burden of a tax or fee to other groups in the economy. Such shifts would occur through changes in the prices of their products or the prices that they pay to acquire labor or materials used to make garments. The unavailability of data on supply and demand conditions in specific markets, such as the markets for garments and garment industry labor in the United States and the CNMI, prevented GAO from estimating the ability of the garment industry in the CNMI to shift its tax burden compared with the ability of the garment industry in the United States to do the same.

[10]Although some tax data were unavailable, the unmeasured taxes and fees that CNMI and U.S. garment manufacturers may have paid are likely to be small relative to the measured taxes and fees. Therefore, even if GAO had been able to include these data, the finding that garment manufacturers in the CNMI pay taxes and fees that represent a higher percentage of gross receipts than do garment manufacturers in the United States would not likely have changed.

[11]Because of processing and publishing lags, no published data beyond 1996 are yet available.

Agency Comments and GAO's Evaluation

GAO provided copies of a draft of this report to the Governor of the CNMI and the Department of the Interior for their review and comment. The CNMI did not provide an overall assessment; however, it made several suggestions for including additional information. In particular, it suggested that GAO (1) add information showing that the percentage of the total workforce employed by the CNMI government is smaller than in Guam or the United States; (2) state that additional nonwage benefits, such as health care, given to foreign workers tend to hold down their wages, while the wages of local workers tend to be higher to compensate for the lack of such benefits; and (3) attribute the high unemployment rate among U.S. citizens in the CNMI and a similarly high rate in Guam to the recent economic recession in Asia. GAO believes that comparing the total workforce of the CNMI to that of Guam and the United States would be misleading because the CNMI workforce includes a large proportion of foreign workers who temporarily reside in the CNMI and are primarily employed in the private sector. Guam and the United States do not have similar proportions of foreign workers to total workforce. GAO also believes that there are insufficient data on the actual value of benefits, such as health care, received by all workers or on deductions to foreign workers' wages to be able to asses the net value of these benefits. Furthermore, GAO does not believe that there is enough information about the actual nature and causes of unemployment in the CNMI to attribute the unemployment to the economic recession in Asia.

The Department of the Interior stated that while GAO's report accurately depicts the dominant role of the garment and tourist industries in the CNMI's economy, the economic analysis underlying the report is flawed because it did not evaluate the effect of these dominant industries and their alien employees on the residents who are U.S. citizens and the economic development of the CNMI. GAO disagrees that the economic analysis in the report is flawed. Contrary to the Department's assertion, the report evaluates the impact of the garment and tourist industries and the use of foreign workers on the CNMI economy and finds that the local resident population—most of whom are U.S. citizens–have benefited from the economic growth and development in the past 20 years because incomes and employment opportunities have increased with economic growth. The growth in the economy has been driven by the growth of the garment and tourist industries and the use of foreign workers. The Department also believes that the report gives an erroneous impression that an economy based on two dominant industries and foreign labor is beneficial in the long run. GAO's report does not give this impression. While clearly laying out the

benefits provided to date, GAO's report clearly states that the CNMI's reliance on the garment and tourist industries and on foreign workers makes it vulnerable to outside events that impact either industry or the economy's access to foreign workers. Therefore, GAO agrees with the Department that the future development of the CNMI economy is a concern.

The Department questioned the validity of GAO's comparison of the CNMI's revenue-raising efforts with those of other outlying areas. In particular, the Department questioned the inclusion of the Freely Associated States among the outlying areas and GAO's method for calculating revenues from local sources and federal transfers for Guam and the CNMI. Although the Freely Associated States are sovereign nations, GAO believes that they should be included because they receive federal funds, they have a shared history with the CNMI, and their citizens have the right of residency in the CNMI. The Department stated that revenue collected by the CNMI government from the user fee that the garment industry pays on garments exported to the United States should be considered federal transfers rather than local revenue. GAO disagrees because nothing required the CNMI to impose a user fee on garment exports. Instead, the decision to apply the user fee was an autonomous act of the government of the CNMI, independent of the exemption from U.S. tariffs. Therefore, it is appropriate to include the revenue received from the user fee as local revenue when evaluating the revenue-raising effort of the CNMI.

The Department further asserted that the taxes and fees actually borne by the garment industry in the CNMI may be quite small because the user fee is shifted to other groups. GAO did not address this issue because data limitations prevent a reliable estimate of the extent to which specific economic groups actually bear the burden of these taxes. The Department also said that the employer's share of Social Security taxes, which GAO included in calculating the taxes and fees paid by the garment industry in the CNMI, should not be included. GAO disagrees because these taxes are included for U.S. garment manufacturers; hence, it is appropriate to include them for the CNMI industry as well.

More detailed discussion of the comments from the CNMI and the Department of the Interior are included at the end of chapters 2 and 3. These agencies also provided clarification on several technical points that have been included in the report as appropriate. The full text of the comments and GAO's responses are included in appendix III for the CNMI and appendix IV for the Department of the Interior.

Introduction

The Covenant establishing the Commonwealth of the Northern Mariana Islands (CNMI), a U.S. territory in the western Pacific, gave the CNMI authority to establish its own immigration and minimum wage policies. The CNMI has used this authority (1) to allow many foreign workers, primarily from the Philippines and China, to enter and work in the CNMI and (2) to establish a minimum wage, currently $3.05 per hour, that is substantially below the minimum wage in the United States of $5.15 per hour. The foreign workers are employed throughout the economy but work primarily in the garment and tourist industries, which are the two largest industries in the CNMI. The garment industry in the CNMI has grown rapidly since commonwealth status was obtained because garments exported from there to the United States are exempt from U.S. textile quotas and import tariffs or duties. In addition, the garments can be sold with labels identifying them as having been made in the United States. The tourist industry also grew rapidly until 1997 but has declined since then because of the downturn in the economies of Asian countries.

Some Members of the Congress and others have expressed concern that the garment industry in particular and its foreign workers may have a negative fiscal impact on the CNMI government. Specifically, they have suggested that the costs of providing infrastructure to support the garment industry and of providing government services, such as health care and education, for the industry's workers and their dependents may exceed the increased government revenue the industry generates. Conversely, others have expressed the view that the garment and tourist industries and the use of foreign workers have contributed substantially to the growth of the CNMI economy. Specifically, they believe that the revenue generated from these industries has contributed significantly to maintaining an economy that is self-sufficient and not as dependent on federal subsidies as are the economies of other outlying areas.[1] However, there is uncertainty about whether the revenue-raising efforts of the CNMI, particularly the level of taxes and fees paid by the garment industry, are sufficient to meet local needs, necessitating the expenditure of federal funds to subsidize the CNMI

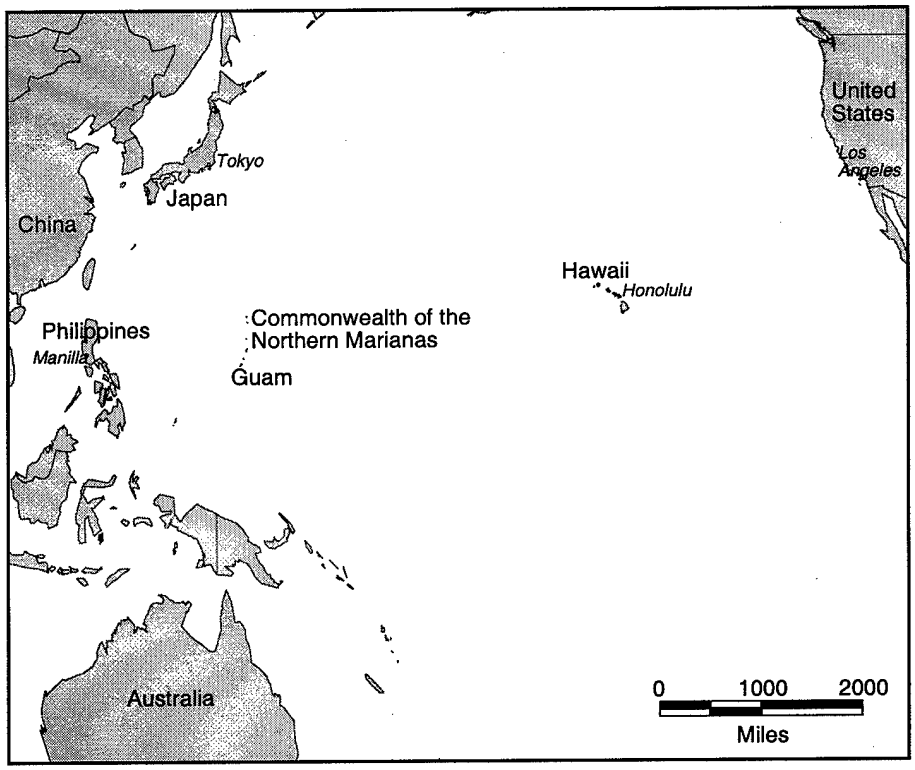
[1]In this report, we use the term outlying areas to include, in addition to the CNMI, American Samoa, Guam, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, and the Freely Associated States (the Republic of the Marshall Islands, the Federated States of Micronesia, and the Republic of Palau). The Freely Associated States are former components of the Trust Territory of the Pacific Islands that are now sovereign nations with compacts of association with the United States. American Samoa is omitted from the comparisons in this report because no current data for locally derived government revenues are available for that territory.

economy. Furthermore, there are additional concerns about the appropriateness of using foreign workers to manufacture garments in the CNMI that are sold in the United States with a label identifying them as having been made in the United States and about possible violations of existing labor and worker safety laws. These include nonpayment of overtime pay rates for working beyond 40 hours per week and providing workers' housing that does not meet minimum safety and health standards.

Historical Background on the Relationship Between the United States and the Northern Mariana Islands

The Northern Mariana Islands are a group of 14 islands in the Pacific Ocean, lying just north of Guam (see fig. 1). The Islands are located about 3,200 miles west of Honolulu, 5,500 miles west of Los Angeles, 1,500 miles south of Tokyo, and 1,400 miles east of Manila.

Figure 1: Map of the Pacific Showing the Northern Mariana Islands



The United States took control of the Northern Mariana Islands from Japan after heavy fighting during the latter part of World War II. In July 1947, the U.S. Congress approved by joint resolution the Trusteeship Agreement for the former Japanese Mandated Islands,[2] making the United States responsible to the United Nations for the administration of the Northern Marianas and other island groups, such as the Marshall Islands. This agreement established the United Nations Trust Territory of the Pacific Islands, with the Northern Mariana Islands constituting one of the districts of the Trust Territory. Under this agreement, the United States was obligated to promote the political, economic, social, and educational advancement of the Islands' inhabitants. In the 1950s and early 1960s, the Northern Marianas were isolated from outsiders except U.S. military

[2]Japan had a mandate from the League of Nations to exercise authority over these islands.

personnel. The Americans built roads, power stations, sewerage and water systems, hospitals, and schools, but the isolation kept substantial economic development from occurring. Apart from the military activity, the economy of the Northern Marianas consisted of subsistence farming and fishing, small-scale manufacturing, and trading.

Subsequently, the Northern Marianas sought a future political status that provided self-government and permanent ties to the United States. Hence, the Northern Marianas began negotiating differing political arrangements with the United States. As a result of these negotiations, in March 1976, President Ford signed a joint resolution of the Congress approving the Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union With the United States of America (P.L. 94-241).

The first elected government took office in the Northern Marianas in January 1978, although the Islands remained a part of the Trust Territory of the Pacific Islands under the jurisdiction of the Secretary of the Interior.[3] However, by Presidential Proclamation of November 3, 1986, and as a result of a valid act of self-determination pursuant to section 1002 of the Covenant, the Northern Mariana Islands ceased to be bound by the United Nations Trusteeship Agreement of 1947. Accordingly, the Northern Mariana Islands became a commonwealth in political union and under the sovereignty of the United States. The Office of Insular Affairs within the Department of the Interior is responsible for assisting the CNMI in achieving its political, economic, and social goals.

Key Provisions of the Covenant Affect Wages, Exports, Immigration, and Taxes

The Covenant establishes a unique political relationship between the CNMI and the United States. It places the CNMI under U.S. sovereignty and provides for U.S. citizenship for people born in the CNMI, yet pledges self-government for local affairs. A basic objective of the Covenant is to encourage economic growth and a standard of living comparable with that in the United States. Accordingly, the Covenant provides several economic incentives. Included among them are that (1) the CNMI controls its minimum wage because the U.S. minimum wage was considered too high for the developing Islands' economy and (2) businesses in the CNMI receive favorable treatment for certain exports to the United States. All such exported articles are exempt from federal excise taxes, and articles that are made in the CNMI that do not contain foreign substances valued at

[3]This jurisdiction is pursuant to Executive Order 11021, May 1962.

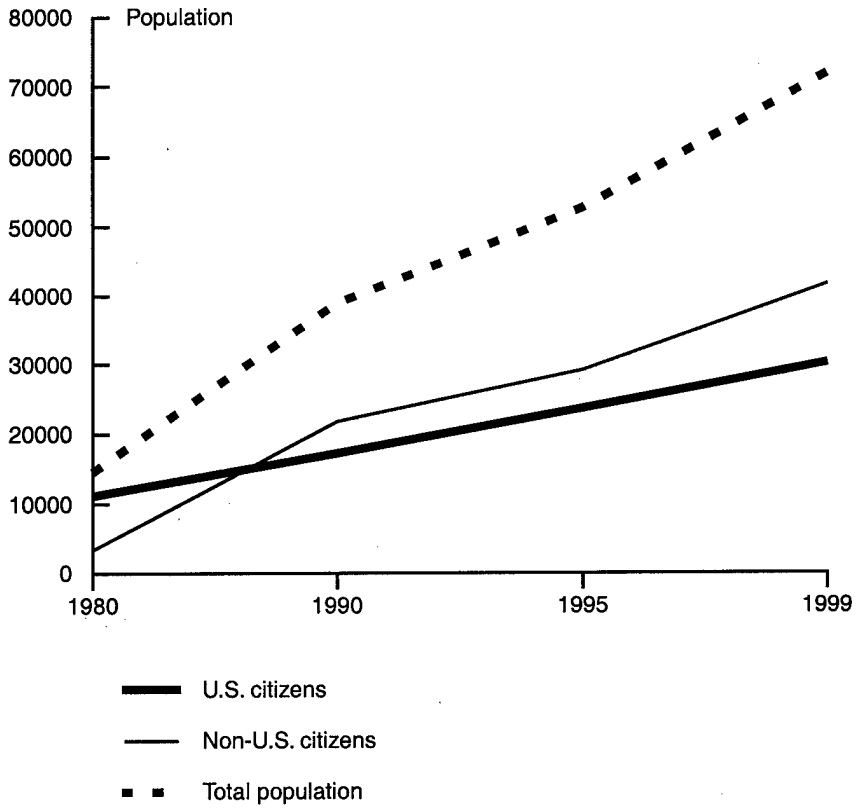
more than 70 percent of the articles' worth are exempt from U.S. textile quotas and from U.S. customs duties. In addition, articles made in the CNMI are entitled to bear labels identifying them as having been made in the United States. These features give garment manufacturers in the CNMI greater access to the U.S. market than is available to garment manufacturers in many other nations.

The Covenant also provides that the CNMI controls its own immigration. This provision was included because local representatives were concerned that existing U.S. immigration laws would permit excessive immigration to the Islands from neighboring Asian countries under terms that would allow these immigrants to become U.S. citizens, which would permanently overwhelm the local culture. In addition, local representatives recognized that the native labor pool of the Northern Marianas was too small and did not have all the skills needed to support economic development. Therefore, once established, the CNMI developed an immigration policy that allows and encourages foreigners to work in the CNMI under temporary, but renewable, work permits that do not lead to U.S. citizenship.[4] Many foreigners have entered the CNMI to work or to open and operate businesses. In fact, as a direct result of the policy decision to restrict immigration but permit a large growth in noncitizen residents, the growth rate of the population of foreign workers and other non-U.S. citizens has outpaced that of the population of U.S. citizens, and at present, noncitizens outnumber citizens. About 79,000 people reside in the CNMI, approximately 90 percent of whom live on Saipan, which is the major business center and the capital of the CNMI. Currently, about 72,000 people live on Saipan and about 42,000, or 58 percent, of them are not U.S. citizens. Figure 2 shows the rapid rate of population growth on Saipan by citizenship status from 1980 to 1999.[5]

[4]Not all noncitizens are foreign workers brought in under the CNMI's worker permit system. Some come from the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau. Citizens of these countries have the right of residency and employment in the CNMI. Other noncitizens are business owners and their families who are allowed to stay in the CNMI as long as they remain in business and meet certain requirements.

[5]We have used Saipan rather than the entire CNMI for this figure because data for population by citizenship status of the other islands are not available after 1995.

Figure 2: Population Growth on Saipan, CNMI, 1980 to 1999



Source: "Recent Trends in Population, Labor Force, Employment, Unemployment and Wages: Commonwealth of the Northern Mariana Islands, 1973 to 1999," draft 1, CNMI Department of Commerce, July 1999.

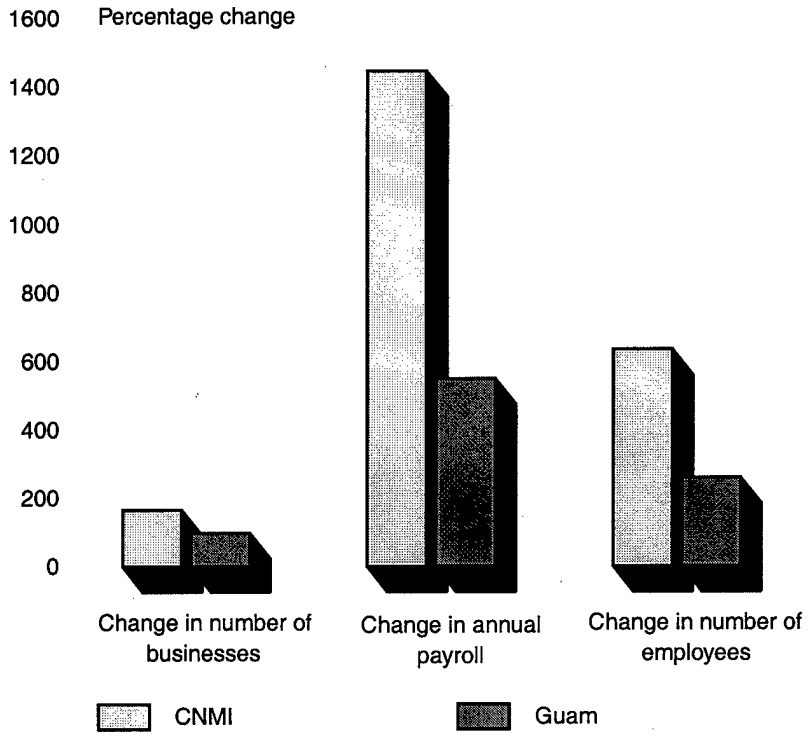
The CNMI government relies on revenue derived locally (taxes, fees, charges, etc.) and on payments from the U.S. Treasury. The Covenant allows the CNMI to establish its own tax and fee structure. As a result, important differences exist in the taxation of business income between the CNMI and the United States. In particular, garment manufacturers in the CNMI are required to pay a user fee to the CNMI government equal to 3.7 percent of the gross value of their exports to the United States and a tax of up to 5 percent on the gross receipts from sales they make in the CNMI. They are also required to pay a fee to the government for each nonresident they employ. In contrast, garment manufacturers in the United States are required to pay income taxes (sometimes state and local as well as federal), property taxes and sometimes sales taxes.

The Economy Has Grown Rapidly Since 1980

Since 1980, the rate of growth of the CNMI economy has been large by any measure. Employment, total payroll, the number of businesses, and total receipts in the private sector have all grown rapidly. Figure 3 shows the percentage growth of several economic variables for the CNMI and Guam.[6] The figure shows that the CNMI economy has been expanding and that for the variables measured, the rate of growth has been greater than in Guam.

[6]We used Guam for a comparison because of its geographical proximity to the CNMI and because both have large tourist industries and long-standing relationships with the United States. We could not calculate the change in income in constant dollars because we were unable to find a consumer price index for the CNMI that went back to 1980. Even had we done so, there are many problems with using such an index when the types of goods being consumed are changing. In an economy that has grown as rapidly as the CNMI's has since 1980, it is likely that the types of goods people routinely purchase–their so-called market basket–would be very different today than they were 20 years ago. Therefore, measuring the change in the price level of a fixed market basket of goods would not accurately measure the change in the cost of living.

Figure 3: Rate of Change in Selected Economic Variables for the CNMI and Guam, 1982 Through 1997



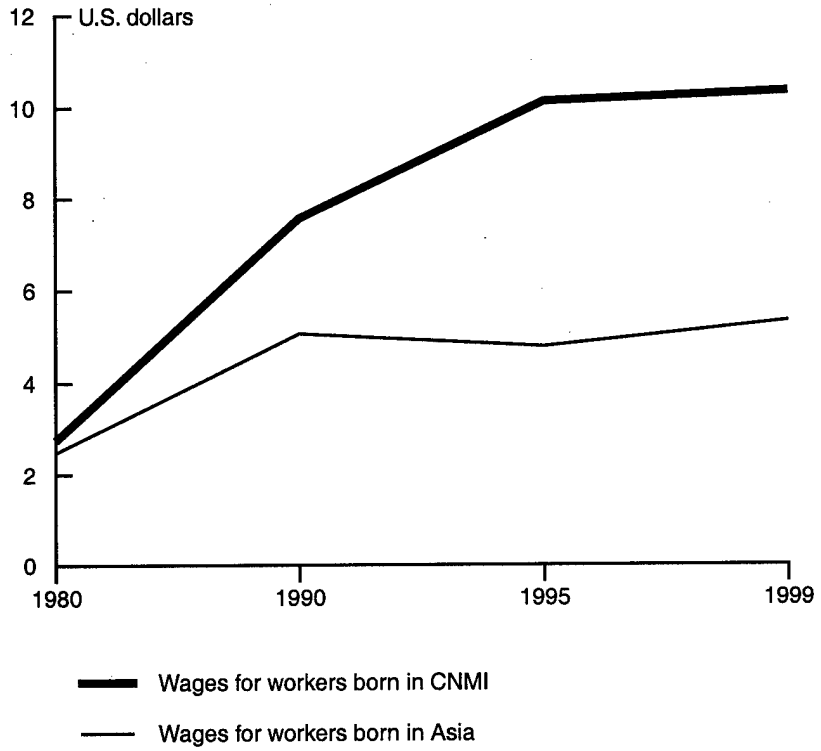
Sources: "1997 Economic Census of Outlying Areas: Construction Industries, Manufacturers, Wholesale Trade, Retail Trade, and Service Industries, Northern Mariana Islands" and "1997 Economic Census of Outlying Areas: Construction Industries, Manufacturers, Wholesale Trade, Retail Trade, and Service Industries, Guam," U.S. Department of Commerce, Economics and Statistics Administration, Bureau of the Census.

The wages and incomes of local residents and foreign workers have generally risen over the period from 1980 to 1999, with more rapid growth occurring in the 1980s. Figure 4 shows the nominal wages for local and foreign workers in the CNMI during that period.[7] The wages of local

[7]We did not calculate the change in income in constant, or inflation-adjusted, dollars because we were unable to find a consumer price index for the CNMI that went back to 1980. Furthermore, the finding that the wages of local workers rose faster than foreign workers' wages from 1980 through 1999 would be the same whether we adjusted for price level changes or not.

workers in 1980 were close to the wages of foreign workers, but local workers' wages grew faster over the period up to 1999.

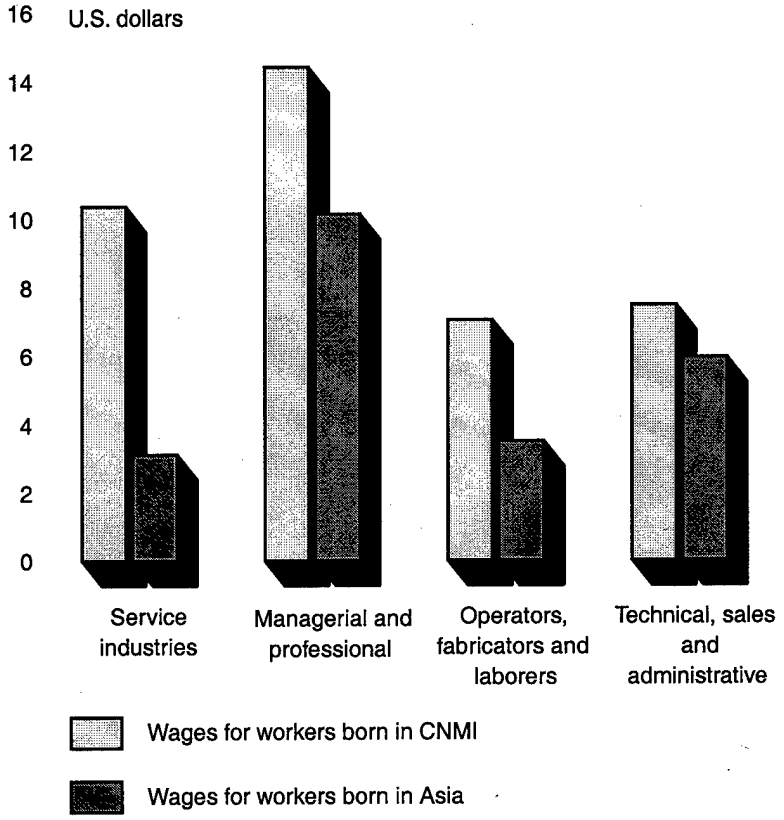
Figure 4: Average Hourly Wages on Saipan, CNMI, 1980 to 1999



Source: "Recent Trends in Population, Labor Force, Employment, Unemployment and Wages: Commonwealth of the Northern Mariana Islands, 1973 to 1999," draft 1, CNMI Department of Commerce, July 1999.

Many foreign and local resident workers currently earn more than the CNMI's minimum wage. Figure 5 shows average wages in 1999 for selected occupations by place of birth of the worker. This figure also shows that the difference between wages earned by those born in the CNMI and those born in Asia is more pronounced in some occupations than in others. Specifically, a greater percentage difference exists between local and foreign workers' wages in less skilled occupations–such as the service industries and operators, fabricators, and laborer–than in more skilled positions–such as managerial and professional or technical, sales, and administrative positions.

Figure 5: Average Hourly Wages in Selected Occupations, by Place of Birth, 1999



Source: "Recent Trends in Population, Labor Force, Employment, Unemployment and Wages: Commonwealth of the Northern Mariana Islands, 1973 to 1999," draft 1, CNMI Department of Commerce, July 1999.

The Use of Foreign Workers and Other Issues Are Controversial

Substantial controversy surrounds the use of foreign workers to manufacture garments in the CNMI that are then exported to the United States and sold with a label identifying them as having been made in the United States. One area of controversy concerns the appropriateness of allowing garments to be sold in the United States with a "Made in the U.S.A." or similar label when the workers are mostly noncitizens and many are paid less than the U.S. minimum wage. Interested parties in the United States have argued in favor of legislation that would make the immigration and minimum wage policies of the CNMI equivalent to those of the United States if such labeling is to remain. Other parties have stated that such

changes, particularly restrictions on the use of foreign workers, would have a serious negative impact on the economy of the CNMI.

Concerns have also been raised about possible violations of existing labor and worker safety laws and, in general, about the exploitation of foreign workers. In the early 1990s, the U.S. Department of Labor cited a number of garment factories in the CNMI for violations of federal wage and labor laws.[8] In addition, the U.S. Department of Labor's Occupational Safety and Health Administration began to cite businesses in the CNMI for providing foreign workers with living quarters that did not meet minimum safety and health standards. Stories in the print and broadcast media have alleged many concerns, including substandard working and living conditions; labor law violations, such as nonpayment of overtime pay rates for working beyond 40 hours per week; leaving workers stranded and without any means to feed themselves or to return to their countries of origin; and forced prostitution.

These concerns have led to several lawsuits. Three class action lawsuits were filed on behalf of garment workers in the CNMI in February 1999. Two of the lawsuits were filed in California: one in state court and the other in federal court. The defendants in these suits include many leading American retailers and brand name garment manufacturers. The plaintiffs allege in the state case that the defendants trafficked in "hot goods" made in violation of California's business practices and engaged in misleading advertising by not adhering to their codes of conduct. In the federal case, the plaintiffs allege violations of the Racketeer Influenced and Corrupt Organizations Act and international human rights law. Nine defendant companies have settled the federal lawsuit with the plaintiffs, but other defendants remain.[9] Those companies that reached settlement agreed to establish a fund to finance an independent monitor of working conditions in garment factories in the CNMI, to make payments to workers, to create a public education campaign, and to pay attorneys' fees. The third lawsuit was filed in federal court in the CNMI. In that lawsuit, the plaintiffs allege violations of wage and hour laws, including the minimum wage law of the CNMI, by various garment manufacturers in the CNMI. In addition to those lawsuits, the federal government filed two civil rights lawsuits against one

[8]All aspects of the federal Fair Labor Standards Act, except for the minimum wage provision, apply in the CNMI.

[9]For the remaining defendants, the case has been moved to Hawaii.

of Saipan's largest garment manufacturers for discriminating against pregnant workers because the company refused to allow them to collect their benefits and for attempting to fire a worker for trying to organize a union.

The CNMI Department of Labor and Immigration believes that working conditions in the garment industry have improved in recent years because of the enhanced law enforcement by the Department and pressure from buyers in the United States. In addition, the Philippines maintains a consulate in the CNMI to assist its citizens who work there. This assistance includes reviewing employment contracts to make sure that they comply with existing laws. Also, supporters of the current status under which the CNMI has the authority to set its own wage and immigration policies point out that foreign workers in the CNMI generally receive higher wages and more protection than workers in other developing countries, where businesses are not subject to the Fair Labor Standards Act and the Occupational Safety and Health Act.

The Department of the Interior has raised the concern that children born in the CNMI to mothers who are not U.S. citizens will create substantial costs for local and federal governments until they reach working age. According to data provided by the Department, the percentage of babies born to non-U.S. citizens has been rising since 1985—about 26 percent of all births in the CNMI in 1985 were to mothers who were not U.S. citizens, compared with about 51 percent of the births in 1998. A significant number of these births were to mothers from the Marshall Islands, the Federated States of Micronesia, and Palau—births to mothers from these countries accounted for about 14 percent of all births in the years 1990 through 1993.[10]

Objectives, Scope, and Methodology

To provide information on some of the issues surrounding the CNMI, the conference report accompanying the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 mandated that we complete analyses and reports concerning the CNMI. The conference report was not specific on what these analyses should address. Through subsequent discussions with the offices of the Subcommittees on Interior and Related Agencies of the House and Senate Committees on

[10]As discussed in this report, citizens of these countries have the right of residence in the CNMI, independent of their employment status, and so are considered to be local residents rather than foreign workers.

Appropriations, we agreed to address the following questions: (1) What has been the impact of the garment and tourist industries and the use of foreign workers on the economy of the CNMI? (2) How do the revenue-raising efforts of the CNMI and the payments that the CNMI receives from the U.S. Treasury compare with those of other U.S. territories and Freely Associated States? (3) How do the taxes and fees paid by the garment industry in the CNMI, expressed as a percentage of gross receipts, compare with the taxes and fees paid by the garment industry in the United States? In this report, we address the first question in chapter 2 and the second and third questions in chapter 3.

To determine the impact that the garment and tourist industries and foreign workers had on the economy of the CNMI, we collected and reviewed studies and data from a variety of sources and met with many CNMI and U.S. government officials and knowledgeable individuals in the private sector. These studies were conducted by a variety of entities, including the Office of Insular Affairs, Department of the Interior; the Hay Group, a management consulting company; the Bank of Hawaii; the Business Development Center of the Northern Marianas College; and the Congressional Research Service. We obtained data on a wide variety of economic variables from Census reports, agencies of the CNMI government, and the studies mentioned above. In general, we did not express data on economic variables in the CNMI in constant dollars, even when showing changes over time, because we were unable to find an index of consumer prices for the CNMI that went back to 1980. Even if we had been able to find an index, there would have been problems using it because of major changes in the types of goods and services purchased in the CNMI during this period. Where appropriate, we noted the impact of using an index of price change for the United States in measuring changes over time. However, we did not emphasize those results because of considerable uncertainty about whether such a measure is a good proxy for a measure of cost of living changes in the CNMI.

We discussed the impact of the garment and tourist industries and foreign workers with government officials and individuals in the private sector, both in Washington, D.C., and while visiting the CNMI. The CNMI government officials we met with included the Lieutenant Governor; the CNMI Resident Representative to the United States; the Secretaries of Commerce, Labor and Immigration, and Finance; the Special Assistant for Management and Budget and the Special Advisor for Finance and Budget, Office of the Governor; the Executive Director of the Commonwealth Ports Authority; the President of Northern Marianas College; and the Managing

Director, Marianas Visitors Authority. We also discussed with these officials (1) how the current minimum wage and immigration policies affect the garment and tourist industries and (2) how and to what extent the CNMI government employs the resident and foreign workforce. We also met with officials from the U.S. Department of the Interior's Office of Insular Affairs, both in Washington and the CNMI, and with the Philippine Consul in the CNMI. To gain a private sector perspective, we met with several CNMI Chamber of Commerce officials, owners of businesses in the CNMI, the manager of a major resort hotel on Saipan, the Executive Director of the Employers Council, the Executive Director of the Saipan Garment Manufacturers Association, the chief legal counsel and a vice president of a major garment manufacturer, several lawyers, and real estate brokers with substantial knowledge of the CNMI.

To determine how the revenue-raising efforts of the CNMI and the payments that the CNMI receives from the U.S. Treasury compare with those of other U.S. territories and Freely Associated States, we obtained data on these outlying areas and on their governments' general revenues, including revenue from local sources and payments from the U.S. Treasury. We used general rather than total revenue as the basis for comparison because the seven outlying areas included in our comparisons all collect the types of revenue included in general revenue: taxes, fees, charges for services, miscellaneous revenue, and payments from the U.S. Treasury.[11] We obtained revenue data from the General Purpose Financial Statements from the outlying areas for fiscal years 1994 through 1997.[12] We recategorized these data using the Bureau of the Census's classification guidelines for government revenue to compare these areas' revenue-raising efforts.[13] Using the guidelines, we compiled total revenue, general revenue,

[11]Not all areas collect all types of total revenue, such as utility, insurance trust, and liquor store revenue.

[12]The financial statements were audited by independent auditors in accordance with the requirements of OMB Circular A-133, revised June 4, 1997, which requires, pursuant to the Single Audit Act of 1984 (P.L. 98-502), that state and local governments that expend federal aid undergo independent audits of their financial activities. (Circular A-133 rescinds Circular A-128, issued Apr. 12, 1985.)

[13]The governments of these areas differ in size, activities, organization, financial structures, and reporting systems. Census has developed a set of standardized concepts and definitions, including revenue classification guidelines, to describe government financial activities in a meaningful and comparable fashion. In particular, the guidelines eliminate the difficulties caused by different governments giving the same revenue collection activity different names.

locally derived revenue, and payments from the U.S. Treasury for each outlying area by aggregating the revenue from different financial accounting funds. As agreed with the staff of the relevant congressional committees, in measuring federal transfers and grants to the outlying areas, we limited the scope of our comparison to intergovernmental transfers and grants. We did not include federal payments directly to individuals residing in the outlying areas, federal payments for services rendered, in-kind assistance, or the non-imposition of the federal income tax on residents of the U.S. territories.

To express locally derived revenue as a percentage of gross domestic product (GDP), we obtained GDP estimates for the outlying areas from various organizations, including the Central Intelligence Agency, the United Nations, the World Bank, the International Monetary Fund, the Asian Development Bank, the Bureau of the Census, the Bank of Hawaii, and the areas' governments. We discussed the limitations of the GDP data with knowledgeable individuals. The economic data available for the outlying areas are limited, making it difficult to make precise estimates of GDP for those areas. Various organizations have made different estimates of GDP for the same area and year. We used all the published estimates that we found because we had no basis to determine which were superior.

To determine how the taxes and fees paid by the garment industry in the CNMI, expressed as a percentage of gross receipts, compare with taxes and fees paid by the garment industry in the United States, we identified and aggregated the taxes paid by the two industries and divided them by the industries' gross receipts. For the CNMI, we obtained data on taxes paid and gross receipts earned from 1992 through 1998 from the CNMI Department of Finance. We estimated the employer's share of the Social Security taxes that the garment industry was required to pay directly to the federal government by applying the appropriate tax rates to wage and salary data provided by the CNMI Department of Finance. The data we obtained were sufficiently detailed to permit us to exclude the wages and salaries that were exempt from these taxes. For the United States, we obtained these data for 1991 through 1996 from published Internal Revenue

Service documents.[14] Because of processing and publishing lags, no published data beyond 1996 are yet available.

We discussed with knowledgeable individuals the limitations of the garment industry tax data available to us and the limitations of using the ratio of taxes paid as a percentage of gross receipts for comparing the tax burdens borne by the CNMI and U.S. garment industries. Data on taxes paid are unavailable for a few of the taxes paid by garment manufacturers in each jurisdiction. In addition, taxes paid can be a misleading indicator of tax burden when taxes levied on business are actually borne by other groups such as consumers or workers. The unavailability of data on supply and demand conditions in specific markets, such as the markets for garments and garment industry labor in the United States and the CNMI, prevented us from estimating the ability of the garment industry in the CNMI to shift its tax burden compared with the ability of the garment industry in the United States to do the same. However, taxes paid as a percentage of gross receipts was the best proxy for tax burden available to us. We did not have sufficient data from either tax returns or financial statements for CNMI garment manufacturers to estimate net economic income. Thus, we could not measure net economic income, or the ability to pay taxes, for this industry.

We conducted our review from February 1999 through February 2000 in accordance with generally accepted government auditing standards. In conducting our work, we did not independently verify or test the reliability of the data provided by the CNMI government or of the data obtained from other sources. However, we compared data from different sources for consistency and relied on the best data available. Furthermore, in agreement with the offices of the responsible subcommittees, we did not assess whether the Covenant should be changed to eliminate the CNMI's authority to control its own immigration and minimum wage policies or whether the labor and immigration policies, and the manner in which they

[14]See *Statistics of Income: Corporation Source Books,* Internal Revenue Service, 1991, 1993, and 1995 editions; and *Statistics of Income: Corporation Income Tax Returns,* Internal Revenue Service, 1992, 1994, and 1996 editions. The data used were for "apparel and other textile products manufacturing" by "active corporations with and without net income in that year." The Internal Revenue Service classifies a business as garment manufacturing when this activity accounts for the largest percentage of its total receipts. Statistics for the garment manufacturing industry may be either understated by amounts reported by corporations whose principal activity lies elsewhere or overstated by amounts reported by corporations classified as being in the garment industry but having substantial operations in other industries.

are implemented, have contributed to labor abuses or poor housing conditions of foreign workers in the CNMI. Nor did we assess the sociological and political ramifications of the presence in the CNMI of a large population of noncitizens. We are currently reviewing the system used by the government to track immigration into and out of the CNMI.

The Impact of the Garment and Tourist Industries on the CNMI Economy

The garment and tourist industries contribute directly to the CNMI economy through the creation of jobs and the production of goods and services for export and indirectly through purchases of local goods and services from other industries and by taxes and fees paid to the government. With respect to the related fiscal impact of these industries on the budget of the CNMI government, the garment and tourist industries and the workers that they employ require government spending for services and infrastructure. For a variety of reasons, however, we believe that the conclusion of a January 1999 study commissioned by the Department of the Interior that this spending exceeds the contributions that these industries make to the revenue of the CNMI government is questionable. The garment and tourist industries are dependent on foreign workers because the labor pool of local residents is insufficient to support an economy of the size and scope that exists in the CNMI. In fact, all sectors of the economy, including the government sector, employ foreign workers. The local resident population of the CNMI has benefited, economically, in the form of higher incomes and better employment opportunities, from the growth of the garment and tourist industries and from the presence of foreign workers. In spite of its rapid growth and development, the CNMI's economy is fragile because of its reliance on only two industries for the bulk of its private sector employment.

The Garment and Tourist Industries Drive Economic Growth and Development

The garment and tourist industries are the source of most of the economic activity in the CNMI. Both have grown rapidly during the past two decades, and their growth has caused the development of other businesses and contributed to the growth of the government sector. According to an October 1999 economic study of the CNMI, which we reviewed and found reasonable, the garment and tourist industries, in 1995, accounted–directly or indirectly–for about 80 percent of the employment in the CNMI, about 96 percent of the economy's exports, and about 85 percent of the total production of goods and services in the economy.[1]

Garment Industry Has Grown Rapidly

The garment industry has grown rapidly since its origin in the CNMI in 1983 to 34 businesses in 1999. Since 1983, the garment industry has added about 16,000 jobs, employing about 13,500 foreign and 2,500 local resident

[1] *An Economic Study for the Commonwealth of the Northern Mariana Islands,* Business Development Center, Northern Marianas College, Oct. 1999. This study was sponsored by a grant from the Office of Insular Affairs of the Department of the Interior.

workers, most of these on Saipan. Given that there were about 32,700 foreign and 11,000 local resident workers employed in the entire Saipan economy in 1999, the garment industry employed approximately 41 and 23 percent of all these workers, respectively. The garment industry, which sells its products almost exclusively to buyers in the United States, also generates a large part of the economy's exports. For example, starting at zero garment exports in 1982, exports to the United States had grown to about $273 million in 1994 and, by 1998, had reached approximately $1 billion.

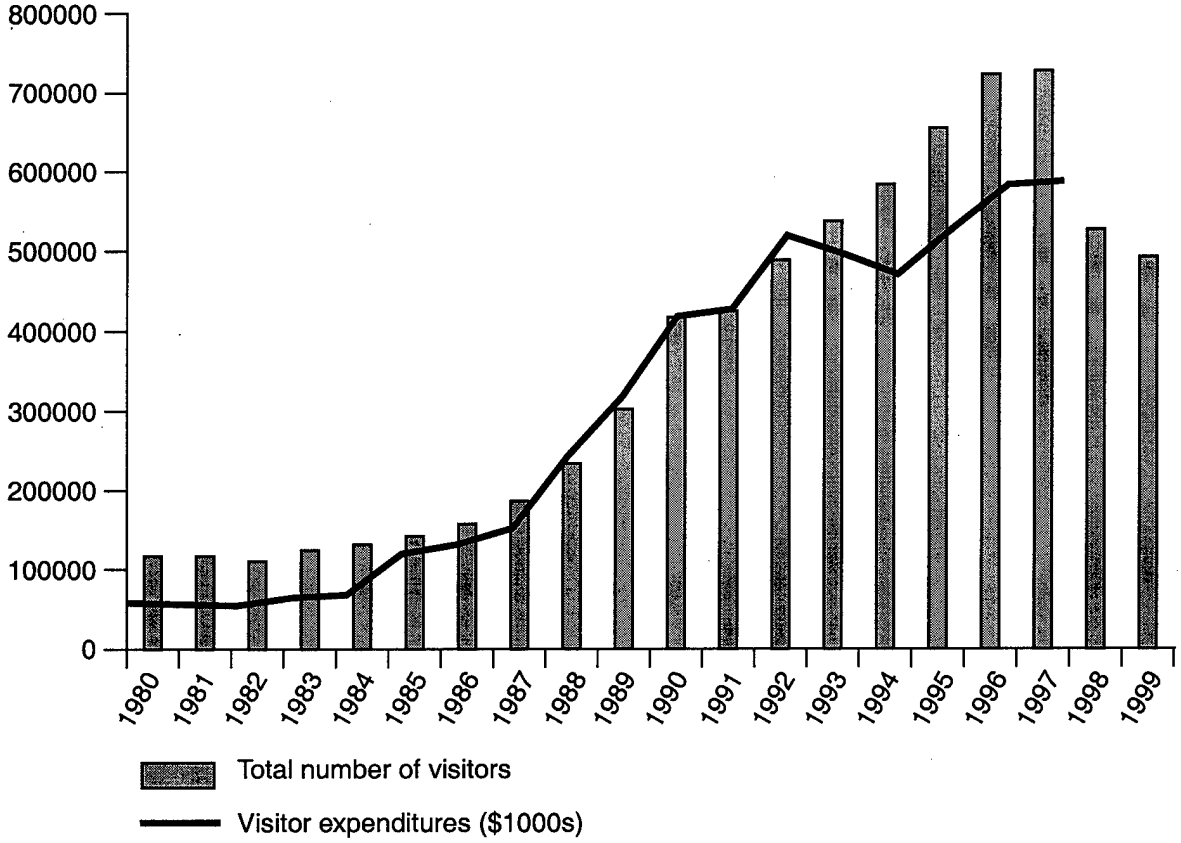
Tourist Industry Peaked in 1997

The tourist industry was already established in 1980, with about 117,000 visitors who spent about $61 million in the CNMI in that year. The industry grew slowly until 1984 and then more rapidly until it peaked in 1997 with 727,000 visitors spending about $585 million. The tourist industry employed about 9,600 workers in 1995—the latest date for which data are available. Of these employees, approximately 6,900 were foreign and 2,700 were local residents. Given that there were about 24,300 foreign and 11,600 local resident workers employed in the CNMI economy in 1995, the tourist industry employed approximately 28 and 23 percent of the foreign and local resident workers, respectively.

Over the Last 2 Years, the Garment Industry Has Grown, but Tourism Is Down

Since 1997, the garment industry has continued its strong growth, but the tourist industry is in a slump. The Asian economic crisis of 1998 and 1999 caused a reduction of over 200,000 tourists–about a 30-percent reduction in the number of visitors coming to the CNMI from 1997 levels. Figure 6 shows the growth of visitor arrivals and spending from 1980 to 1997 and the subsequent drop in tourism. In contrast with the drop in tourism, the garment industry's exports increased by about 30 percent between 1997 and 1998 and were projected to increase by another 9 percent in 1999. The growth in garment production, according to the CNMI, has mitigated the impact of the CNMI's current economic downturn caused by the recession in Japan and other Asian countries.

Figure 6: CNMI Visitor Arrivals and Spending, 1980 to 1999



Note: Data were unavailable for visitor expenditures in 1998 and 1999.

Sources: "1998 Commonwealth of the Northern Mariana Islands Statistical Yearbook," Central Statistics Division, Department of Commerce, and the Marianas Visitors Authority.

Although the continued growth of the garment industry has helped, the CNMI's overall economy is in many ways worse off today than it was 2 years ago. Government revenue is down from its high of $248 million in 1997 to a projected $216 million in 1999, a reduction of about 13 percent, and business gross revenue fell by 14 percent, from $2.6 billion to $2.2 billion from 1997 to 1998. Some CNMI businesses have closed and

others have laid off staff. The unemployment rate among U.S. citizens on Saipan is about 13 percent.[2]

Garment and Tourist Industries Affect Other Sectors of the Economy

The garment and tourist industries are linked to the rest of the economy through the purchases of goods and services from other industries, tax revenue paid to the government, and workers' spending. For example, when hotels buy food from local farmers, they indirectly support farming employment. Similarly, employers rent housing for their foreign workers from local owners of real estate, and these rentals add revenue to the local economy. Tax revenue also supports government employment and pays for government services. To illustrate, in fiscal year 1993, the garment industry paid about $13 million directly in taxes and fees, amounting to slightly less than 10 percent of the government's total revenue of about $139 million that year. By fiscal year 1998, the taxes and fees paid by the garment industry had grown to about $52 million and accounted, directly, for slightly more than 22 percent of the $234 million in total general fund revenue. In 1997–the latest date for which visitor expenditure data are available–the tourist industry directly contributed at least $34 million in business gross receipts taxes and hotel taxes and an unknown amount of excise and personal income taxes.[3] The tourist industry's taxes accounted for at least 14 percent of that year's general fund revenue of $248 million.

Although foreign workers in the garment and tourist industries send much of their earnings back to their countries of origin, the remainder is spent on

[2]According to the CNMI Governor's Office, Guam also has about 13 percent unemployment, and they attribute this to the drop-off of tourism caused by the Asian economic recession. However, the Department of the Interior expressed the opinion that the high rate of unemployment among U.S. citizens in the CNMI is the result of the growth of the economy based on alien labor. We did not determine the causes for the high rate of unemployment among U.S. citizens. However, it should be pointed out that the unemployment rate among U.S. citizens has been high since at least 1990 in spite of the fact that the economy has grown and added many jobs for both local residents and foreign workers over the past 10 years.

[3]The estimate for the tourist industry's contribution to the government's revenue is low because it reflects only hotel and business gross receipts taxes on visitor expenditures, leaving out other important tax sources such as excise taxes or personal income taxes paid by employees or employers. Furthermore, the figures for both industries underestimate their total contribution because they do not include tax revenue generated by other sectors as a result of their economic transactions with the garment and tourist industries. For example, the CNMI Finance Department estimates that the garment industry was indirectly responsible for an additional $24 million, or 10 percent, of government's general fund revenue in 1998 that was paid by other industries doing business with the garment industry.

local goods and services, further stimulating economic activity and employment. For example, according to the CNMI Chamber of Commerce, China and the Philippines are the two most common destinations for long-distance telephone calls from the CNMI because of workers from these countries calling home. Therefore, the local telephone company's revenue is affected by changes in the number of foreign workers employed in the CNMI, which in turn can affect other CNMI businesses. According to the owner of a local business that sells services to the telephone company, the reduction in foreign workers employed in the tourist industry over the last 2 years triggered by the decline in visitors to the CNMI has reduced the telephone company's revenue. She said that this has resulted in the telephone company's reducing its purchases from her business.

Another effect of the garment and tourist industries comes in the form of lower shipping costs for imported goods. The high volume of goods imported into the CNMI to support the garment and tourist industries and the exports of garments to the United States increases the total ship traffic into and out of the CNMI. Higher traffic leads to greater port revenue and also has the effect of making it cheaper to ship consumer goods to the CNMI. Some container ships bringing consumer goods from the United States leave the CNMI carrying finished garments. Without the ability to carry cargo back from the CNMI, shippers would have to charge more to bring goods to the CNMI.

The Department of the Interior's Study Is Critical of the Garment and Tourist Industries, but Its Conclusion Is Questionable

According to a Department of the Interior's study released in January 1999, the garment and tourist industries and the foreign workers they employ have a negative fiscal impact on the CNMI economy.[4] The Interior study concludes that the garment and tourist industries and their workers require more spending for government services and infrastructure than the revenue they contribute to the government. The services and infrastructure include education, health care, public utilities, waste treatment and disposal facilities, roads, airports, and port facilities.

[4] *CNMI Fiscal Impact Report: The Impact of Non-Residents on the Economy and Public Infrastructure of the Commonwealth of the Northern Mariana Islands,* prepared for the Office of Insular Affairs, U.S. Department of the Interior, by Robert W. Rudolph and James C. Nicholas, Jan. 1999.

We believe that the Interior study is methodologically flawed because it understates the contributions made by the garment and tourist industries to the CNMI economy and overstates the impact of these industries and their workers on the need for government services and infrastructure. While these industries and their workers result in a need for increased government spending, the Interior study understates the contributions to government revenue made by the two industries because it does not adequately account for the revenue resulting from the linkages between the garment and tourist industries on one hand and the rest of the economy on the other. These linkages need to be taken into account–as is done in an analysis in a more recent economic study[5]–because most of the production and employment in the economy is attributable to the garment and tourist industries and, consequently, so is much of the government revenue.

[5]*An Economic Study for the Commonwealth of the Northern Mariana Islands, prepared for the Business Development Center,* Northern Marianas College, with funding provided by the Office of Insular Affairs, U.S. Department of the Interior, Oct. 1999.

Similarly, the Interior study overstates the impact of these industries and their workers on government spending by not fully taking into account that foreign workers, on average, use fewer government services than do residents. Of the services they do use, their impact on government spending is likely to be lower than that of the local resident population. For example, while Asian and other nonlocal people accounted for over 52 percent of the total population of the CNMI in 1995, they accounted for less than 13 percent of the students enrolled in CNMI schools in the 1995-96 school year. In contrast, Chamorros, the largest indigenous group of people in the CNMI, made up about 24 percent of the population in 1995 but accounted for about 58 percent of school enrollment in the 1995-96 school year. Similarly, in fiscal year 1996, Filipino households accounted for over 16 percent of all CNMI households but received less than 8 percent of Nutritional Assistance Program benefits. Moreover, in 1999, about 79 percent of all non-U.S. citizens on Saipan were between 20 and 45 years of age compared with about 31 percent of U.S. citizens in that age range. As a result, non-U.S. citizens are likely to use fewer medical services and have a smaller impact on the provision of government health services and on other services associated with the elderly than the local resident population. Finally, the birth rate is much lower for non-U.S. citizens than for U.S. citizens. For example, according to data provided us by the Department of the Interior, in 1998, the number of children born in the CNMI to mothers who were not U.S. citizens was about 33 per 1,000 women between the ages of 15 and 44 compared with about 117 children born per 1,000 mothers in that age group who were U.S. citizens. While the children of non-U.S. citizens will no doubt impose some costs on local and federal governments until they reach working age, their impact per capita on government expenditures is likely to be smaller than that of the children of local residents.[6]

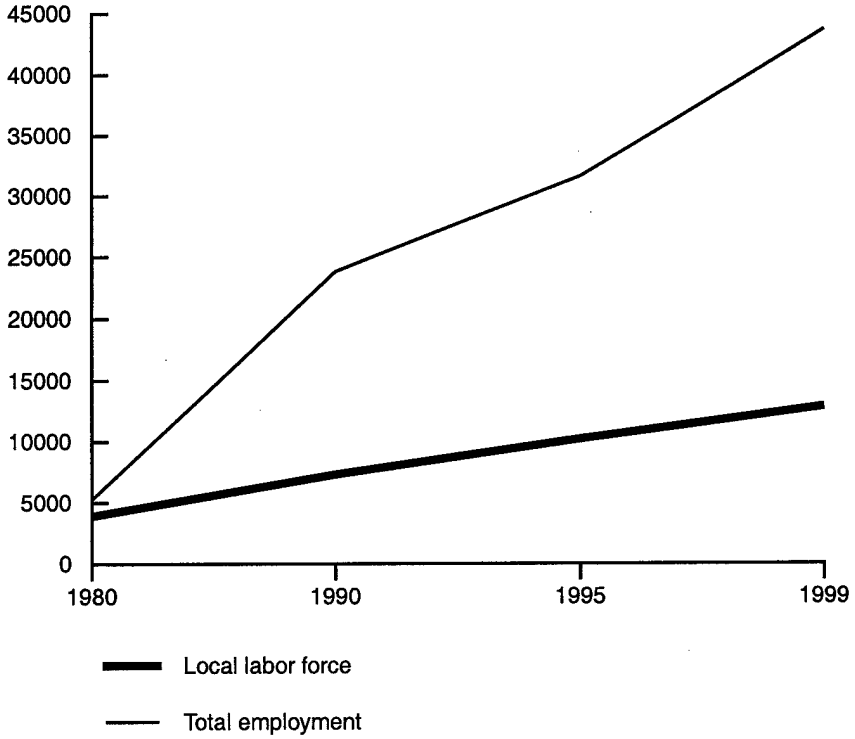
The CNMI Economy Is Dependent on Foreign Workers

The economy of the CNMI could not have grown to its current size and complexity without access to imported labor. To illustrate this point, the total number of local residents in the Saipan workforce in 1999 was about 12,800, including about 11,000 employed and 1,800 unemployed people. This number includes–along with those U.S. citizens born in the CNMI–U.S.

[6]The data provided by the Department of the Interior also show that the birth rates for non-U.S. and U.S citizens alike have fallen from 1990 to 1998—the rates for the two groups fell by about 35 and 31 percent, respectively. If this trend continues, the per capita fiscal impact of the children born to non-U.S. citizens in the CNMI will become even smaller.

citizens from Guam and elsewhere and those non-U.S. citizens born in the Federated States of Micronesia, the Marshall Islands, and Palau, who have the right of residency and employment in the CNMI. Between 4,000 and 4,900 local residents were employed in government positions, between 6,100 and 7,000 worked in the private sector, and about 1,800 were unemployed. In contrast, the size of the workforce in the garment industry alone was about 16,000 in 1999, and total employment was about 43,700. Figure 7 shows the total labor force of local residents and the total number of employed people on Saipan from 1980 to 1999. The gap between total employment and the local labor force has grown over time as the economy has grown and the gap has been filled with foreign labor.

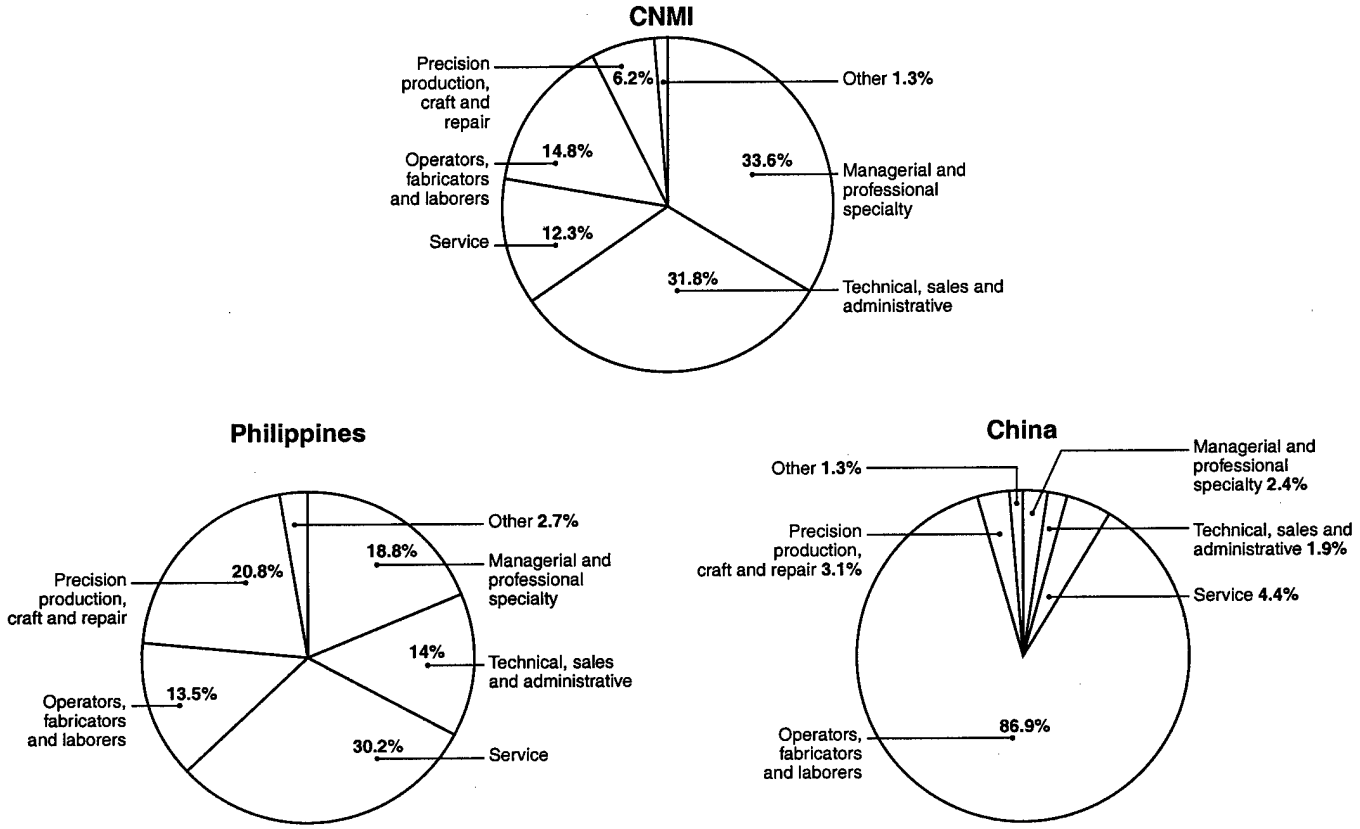
Figure 7: Saipan Employment and Local Labor Force, 1980 to 1999



Source: "Recent Trends in Population, Labor Force, Employment, Unemployment and Wages: Commonwealth of the Northern Mariana Islands, 1973 to 1999," draft 1, CNMI Department of Commerce, July 1999.

In addition to an insufficient number of local resident workers, crucial skills are also in short supply. Representatives of the private and government sectors told us that foreign workers are employed in all sectors of the economy because they bring skills to the CNMI that are simply not available among the local residents. The government sector–which primarily employs U.S. citizens born in the CNMI–hires some foreign workers, for example, as teachers and nurses, because the government cannot find sufficient qualified local residents. While most Chinese workers are employed in the garment industry as machine operators, assemblers, and inspectors, workers from the Philippines are widely distributed across occupations and contribute managerial and professional skills as well as taking less skilled positions. Figure 8 shows the distribution of workers by selected occupations for those born in the CNMI, China, and the Philippines in 1999. This figure shows that employment for the 6,092 workers born in the CNMI is most heavily concentrated in skilled and managerial positions. It also shows that the 16,739 Filipino workers hold a wide range of jobs, while the 12,797 Chinese workers are mostly employed as operators, fabricators, and laborers.

Figure 8: Distribution of Local and Foreign Workers by Occupation and Place of Birth, 1999



Source: "Recent Trends in Population, Labor Force, Employment, Unemployment and Wages: Commonwealth of the Northern Mariana Islands, 1973 to 1999," draft 1, CNMI Department of Commerce, July 1999.

In addition to providing labor services, foreigners own and operate many businesses in the CNMI. In 1992, for example, about 42 percent of the 1,266 businesses in the CNMI were owned by non-U.S. citizens. Foreigners own many types of businesses in the CNMI, from small family-run shops to large garment factories and hotels.

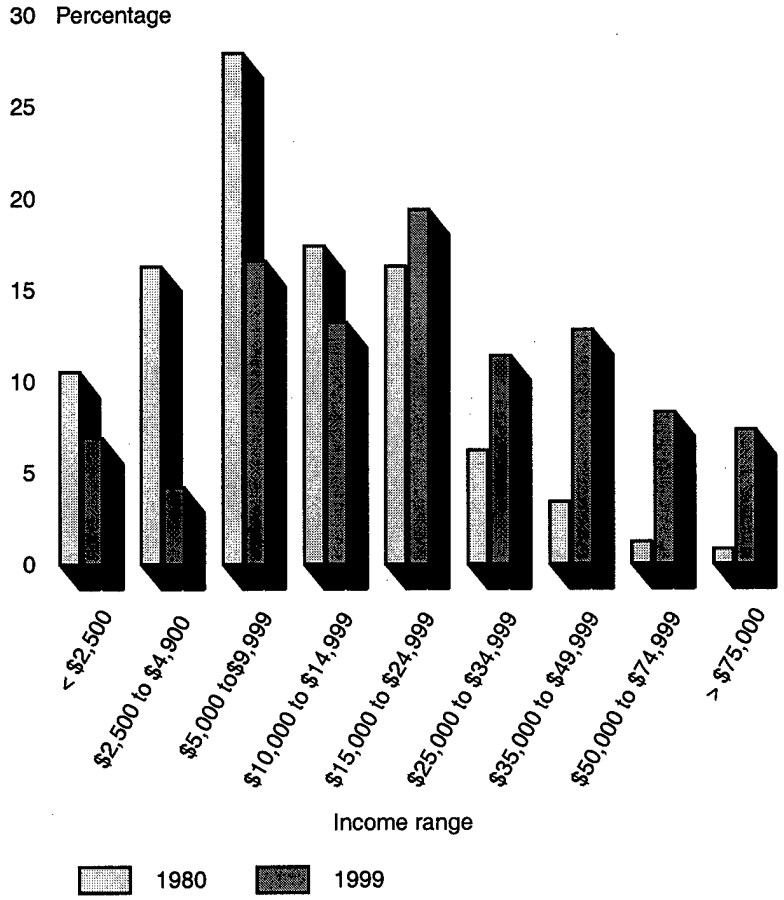
Local Residents Have Benefited From Economic Growth

Much of the increase in local residents' wages since 1980 can be attributed to the CNMI's general economic growth, which has been driven by the garment and tourist industries and by access to foreign workers. Local residents have enjoyed greater employment opportunities, both within the government and in the private sector. For example, on Saipan, the number of jobs held by U.S. citizens grew faster than the population of U.S. citizens between 1980 and 1999–employment increased by about 183 percent, while the population increased by 169 percent. Over the same period, labor participation rates for U.S. citizens on Saipan increased from about 58 percent in 1980 to 68 percent in 1999. In addition to wage income, some local residents have earned income by leasing their land to garment and tourist businesses. Others have enjoyed increased opportunities to operate their own businesses–the number of U.S. citizens on Saipan who were self-employed rose from 80 (or 2.5 percent of those employed) in 1980 to 451 (or 5 percent of those employed) in 1999. Increased tax and fee revenue from the garment and tourist industries and their employees has enabled the government to expand employment and pay higher wages and salaries, actions that have primarily benefited those born in the CNMI who hold most of these government jobs. However, a smaller proportion of U.S. citizens rely on the government for employment now than in 1980–in 1980, about 53 percent of employed U.S. citizens worked for the government, while in 1999, 44 percent were government workers. Median income for Chamorro households–the largest ethnic group among the local residents–increased from about $8,900 in 1980 to $30,700 in 1999, in nominal terms with more rapid growth occurring in the 1980s than in the 1990s.[7] The distribution of income in the CNMI has also changed as the economy has grown. In 1980, household and family incomes on Saipan were heavily concentrated in the three lowest income categories, with over 55 percent of all households earning less than $10,000. By 1999, incomes were more evenly distributed among all income categories, and far fewer households

[7]We could not calculate the change in income in constant dollars because we were unable to find a consumer price index for the CNMI that went back to 1980. Even had we done so, there are many problems with using such an index when the types of goods being consumed are changing. In an economy that has grown as rapidly as the CNMI's has since 1980, it is likely that the types of goods people routinely purchase–their so-called market basket–would be very different today than they were 20 years ago. Therefore, measuring the change in the price level of a fixed market basket of goods would not accurately measure the change in the cost of living. To put the nominal change in incomes into some perspective, we have calculated the change in constant U.S. dollars, using the U.S. GDP deflator. In this case, the change in median household income for Chamorro households in 1999 dollars was from about $17,000 in 1980 to $30,700 in 1999.

were in the lower income brackets. Figure 9 shows the distribution of income for Saipan households in 1980 and 1999 and illustrates the more even distribution across income categories in 1999.

Figure 9: Income Distribution for Saipan Households, 1980 and 1999



Source: "Recent Trends in Population, Labor Force, Employment, Unemployment and Wages: Commonwealth of the Northern Mariana Islands, 1973 to 1999," draft 1, CNMI Department of Commerce, July 1999.

The Heavy Dependence on Two Industries Makes the CNMI Economy Vulnerable to Outside Events

Because of its reliance on only two large industries and on foreign workers, the economy of the CNMI is vulnerable to events that affect these industries or the terms under which foreign workers may enter and work in the CNMI. These events include changes in economic conditions in Asia, possible changes in international trade agreements, and potential legislation.

The downturn in the CNMI economy since 1997 due to the reduction in tourism illustrates the importance of economic conditions outside of the CNMI, particularly in Asia. A revival of the tourist industry depends on an improvement in the economies of Asian countries. Because of the linkages to the rest of the economy and the size of the tourist industry relative to the overall CNMI economy, a revival of the tourist industry would have positive effects throughout the economy.

The future of the garment industry in the CNMI could be influenced by changes in international agreements or legislation that may reduce or eliminate the advantages of manufacturing garments in the CNMI. Currently, garment manufacturers in the CNMI can sell their products to buyers in the United States without import tariffs, these imports are not subject to quotas, and they can bear labels identifying them as having been made in the United States. These features give the garment manufacturers in the CNMI greater access to the U.S. market than is available to the garment manufacturers in many other nations who face import duties, or tariffs, and quotas. However, the 1994 Uruguay Round Agreement on Textiles and Clothing calls for World Trade Organization (WTO) members to eliminate quotas by 2005. Additionally, under this Agreement, the United States agreed to slightly reduce its tariff on imported garments. Therefore, one advantage that the CNMI has over locations in WTO countries is scheduled to end in a few years. The CNMI would continue to have an advantage relative to other WTO members because its garment exports to the United States are not subject to tariff. However, although wages in the garment industry in the CNMI are typically lower than they are in the United States, they are higher than in some WTO member countries. So, whether garment production will leave the CNMI for other WTO members in 2005 and beyond will depend on whether the value of the benefits received from the tariff-free status and the identification of products as having been made in the United States offsets the higher wages paid in the CNMI. If some or all of the CNMI garment industry relocates, this will cause job losses among local residents and revenue losses for the CNMI government.

Whether China becomes a member of the WTO may also affect the garment industry in the CNMI. Currently, because China is not a member of the WTO, the 1994 agreement to eliminate quotas by 2005 does not apply to the quota limiting the export of Chinese garments to the United States. Many garment factories in the CNMI are owned by Chinese companies. Production from these factories has been concentrated in the garment categories for which China has traditionally filled its quota. China is now negotiating for entrance into the WTO.[8] If China becomes a member, depending on the terms of its admission, the quota on garments imported from China might also be eliminated by 2005. If so, the garment industry in the CNMI might be more likely to shrink.

Legislation currently being considered by the Congress could affect the garment industry in the CNMI by giving garment manufacturers in countries in sub-Saharan Africa access to the U.S. market on the same terms as garment manufacturers in the CNMI (except for the identification of their products as being made in the United States). If this legislation becomes law, the future competitiveness of the garment industry in the CNMI will depend on the relative differences in productivity; quality; and cost of materials, labor, and shipping between the CNMI and potential competitors in Africa.[9]

Finally, the high dependence of the CNMI's entire economy on foreign workers puts it at risk if its access to these workers is disrupted. The right of the CNMI to define its own immigration policy and minimum wage can be revoked or modified by the Congress. Two bills introduced in the 106th Congress, H.R. 730 and S. 1052, could make it harder for foreigners to work in the CNMI. Since the CNMI is dependent on foreign workers for most of its labor force, major changes in the availability of these workers or in their terms of employment would have a large impact on the overall economy.

In testimony before the House Committee on Resources on September 16, 1999, the Governor of the CNMI acknowledged that the CNMI's economic downturn was caused by its tourist industry's reliance on Asian economies. The Governor also discussed other potential effects on the economy that might result from a decline in the garment industry. For example, the

[8]Recently, the United States announced its support for the admission of China to the WTO.

[9]The House of Representatives and the Senate each passed bills in 1999 that would, if enacted, liberalize trade with African nations. A conference committee will meet in 2000 to reconcile differences between the bills.

Governor stated that a drastic drop in government revenue would occur in fiscal year 2004 if quotas and tariffs applied to garments produced elsewhere and exported to the United States are removed, causing the CNMI garment manufacturers to leave or reduce their production. He said that the loss of the garment industry not only would reduce general revenue but would also affect the revenue of the Commonwealth Ports Authority derived from garment-related shipments. In addition, without a source of replacement revenue, the loss of the revenue from the garment industry would leave the Ports Authority unable to meet its payments on its long-term bond debt. The loss of the outbound cargo from the garment industry would also mean higher shipping costs for the entire CNMI. The Governor also said that the Commonwealth Utilities Corporation would lose its revenue from the garment industry, which accounts for about one-fifth of its total revenue.

The Governor stated that the government of the CNMI has implemented austerity measures in an attempt to deal with the decline in government revenues resulting from the downturn in tourism. In January 1998, the Governor imposed restrictions on expenditures for personnel, professional services, travel, communications, leased vehicles, and the general procurement of goods and services. These measures have reduced government expenditures by about $52 million. In addition, over 1,000 government positions have been eliminated through attrition and by leaving vacant positions unfilled, and some government offices have implemented a reduction in work hours. However, the Governor recognized that further reductions in government expenditures present major difficulties. According to the Governor, the CNMI is faced with the problem of providing full government services to three islands–in the form of police, utilities, air and sea ports, education, health, and roads–despite a declining economy and without Compact Impact Aid from the federal government. The Governor concluded that if it is to maintain its self-sufficiency, the CNMI must diversify its economy.

Agency Comments and Our Evaluation

Both the CNMI and the Department of the Interior raised concerns about this chapter. While the CNMI did not provide an overall assessment of the report, it suggested that we add additional language in several places. The CNMI suggested that we include information showing that the percentage of the total workforce employed by the CNMI government is smaller than in Guam or the United States. We believe that comparing the total workforce of the CNMI with that of Guam and the United States would be misleading because the CNMI workforce includes a large proportion of foreign

workers, who temporarily reside in the CNMI and are primarily employed in the private sector. Guam and the United States do not have similar proportions of foreign workers to total workforce. The CNMI suggested that our report should state that additional non-wage benefits given to foreign workers tend to hold down their money wages, while the wages of local workers tend to be higher to compensate for the lack of such benefits. However, we believe that there are insufficient data on the actual value of benefits received by all workers or for deductions to foreign workers' wages to accurately assess the net value of these benefits. The CNMI government further suggested that we attribute the high unemployment rate among U.S. citizens in the CNMI and a similarly high rate in Guam to the recent economic recession in Asia. Our report does not attempt to determine the cause of unemployment in the CNMI, and we do not believe that there is enough information about the actual nature and causes of unemployment in the CNMI to do so. In addition, the CNMI government said that we should note in the report that the people of the Freely Associated States who come to live and work in the CNMI place a heavy burden on the government and increase its deficit problem. Our report does not address the issue of the government deficit, and we do not believe that there are sufficient data or a reasonable methodology available to determine how particular groups in the economy affect the CNMI's budget deficit.

The Department of the Interior stated that while our report accurately depicts the dominant role of the garment and tourist industries in the CNMI economy, the economic analysis underlying the report is flawed because it did not evaluate the effect of these dominant industries and their alien employees on the residents who are U.S. citizens and on the economic development of the CNMI. We disagree that the economic analysis in the report is flawed. Contrary to the Department's assertion, the report evaluates the impact of the garment and tourist industries and the use of foreign workers on the economy and finds that the CNMI's local resident population—most of whom are U.S. citizens–has benefited from the economic growth and development in the past 20 years because incomes and employment opportunities have increased with economic growth. The growth in the economy has been driven by the growth of the garment and tourist industries and the use of foreign workers. The Department also stated that the report gives an erroneous impression that an economy based on two dominant industries and foreign labor is beneficial in the long run. Our report does not give this impression. While clearly laying out the benefits provided to date, our report clearly states that the CNMI's reliance on the garment and tourist industries and on foreign workers makes it

vulnerable to outside events that have an impact on either industry or the economy's access to foreign workers. Therefore, we agree with the Department that the future development of the CNMI economy is a concern.

The Department stated that the report answers its objectives narrowly, without reference to the economic, legal, and regulatory context in which the CNMI economy operates. It stated further that the report contains data and observations that are out of context, incorrectly categorized, and misleading. We disagree with this assessment. The report describes in detail the historical, economic, legal, and regulatory context in which the CNMI economy operates and, in our view, presents an objective description of controversial issues. In addition, the report uses data and information from a wide range of sources and presents the results in a balanced, fact-based, and objective manner. The Department also stated that the report does not evaluate the effect of the development and dominance of the garment and tourist industries on the CNMI's population of U.S. citizens and further stated that training and employment of local workers has fallen behind. We disagree with this assessment. While we did not specifically examine the issue of training, the report explains in detail how local residents, most of whom are U.S. citizens, have benefited from economic growth. For example, we point out that the number of jobs held by U.S. citizens has grown faster than the population of U.S. citizens, while labor participation rates increased for U.S. citizens in the period between 1980 and 1999. The report distinguishes between local and foreign residents and workers in the CNMI whenever the data were available to do so.

The Department questioned how much the CNMI economy's growth has contributed to the long-term well being of the CNMI's citizens. It stated that employment of residents has grown little, while the number of foreign workers has doubled since 1995. We do not agree that private sector employment for local workers has grown little since 1995. For example, according to data from the CNMI Department of Commerce, private sector employment of U.S. citizens increased by about 24 percent between 1995 and 1999 on Saipan, while total employment of U.S. citizens, including employment in the government sector, rose by about 22 percent. The employment of non-U.S. citizens increased by about 43 percent over the same period, but this includes about a 27-percent increase in employment of people born in the Freely Associated States and therefore considered local residents of the CNMI. The Saipan economy added about 2,100 jobs for local residents, including about 1,650 jobs for U.S. citizens and 450 jobs

for workers born in Micronesia. During the same period, the economy added about 10,000 new jobs for foreign workers.

The Department stated that under the WTO agreement, the U.S. garment quotas will cease on January 1, 2005, and the artificial advantage enjoyed by the CNMI will come to an end. It concluded that our report ignores the danger of relying on an industry that is scheduled to cease abruptly in 5 years. We disagree that the garment industry will necessarily cease in 5 years' time. The advantages that the CNMI garment industry has over many of its international competitors are three-fold: (1) Garment makers in the CNMI can sell their products to buyers in the United States without import tariffs. (2) The imports are not subject to quotas. (3) The products can bear labels identifying them as being made in the United States. Even if quotas are eliminated as scheduled, the tariff and labeling advantages will remain largely intact, and at this point, it is not possible to determine whether the garment industry will remain viable in whole or in part.

The CNMI Government's Revenue-Raising Effort

The CNMI is more self-sufficient fiscally than other outlying areas. In the years 1994 through 1997, the CNMI government collected about 87 percent of its general revenue from local sources and relied on payments from the U.S. Treasury for about 13 percent. The portion of its budget funded from local sources is higher than that of the other outlying areas. For 1994 through 1997, we estimate that the CNMI's ratio of government revenue derived locally to GDP was between 29 and 45 percent, depending on which published estimate for GDP we used. This estimate is higher than estimates of that ratio for most other outlying areas. It is also higher than the comparable percentage for the United States for all levels of government combined–28 percent in 1996.

Available data suggest that the taxes and fees paid by the garment industry in the CNMI as a share of gross receipts are higher than those paid by the garment industry in the United States.[1] For the period 1993 through 1998, the taxes and fees paid by the CNMI garment industry for which data were available represented about 5.0 percent of the industry's gross receipts. In comparison, for the period 1991 through 1996 (the latest year for which data were available), the taxes paid by the U.S. garment industry represented about 3.3 percent of gross receipts. However, the owners of businesses in the garment industry in the CNMI and the United States may not bear the full economic burden of the various taxes and fees that they pay to their respective governments. Garment manufacturers may be able to shift some or all of the burden of these taxes to consumers, workers, and to investors in other industries. The extent of this shifting is unknown.

The CNMI Is More Self-Sufficient Fiscally Than Other Outlying Areas

The CNMI is less dependent on federal transfers and grants to meet its budgetary needs than other outlying areas. Table 1 shows that locally derived revenue as a percentage of general revenue for the CNMI was

[1]Data were available for most, but not all, of the taxes and fees that the CNMI and U.S. garment industries are responsible for paying. The ratio of industry tax payments to gross receipts for the CNMI industry would likely continue to be higher than that for the U.S. industry if more complete data had been available because the unmeasured taxes and fees paid are likely to be small relative to the measured taxes and fees.

higher than that of the other areas and that transfers and grants from thefederal government were lower than those of the other areas.[2]

Table 1: Percentage of Revenue From Local Sources and Federal Transfers and Grants in Relation to Total General Revenue for the CNMI and Other Outlying Areas, Fiscal Years 1994 Through 1997

Dollars in millions

Outlying area/revenue	1994	1995	1996	1997
CNMI				
General revenue	$221.8	$284.5	$305.9	$326.7
Revenue from local sources	86.1%	86.3%	86.6%	88.1%
Revenue from federal transfers and grants	13.9%	13.7%	13.4%	11.9%
Guam				
General revenue	$807.2	$813.3	$880.3	$876.7
Revenue from local sources	79.5%	82.6%	83.5%	83.6%
Revenue from federal transfers and grants	20.5%	17.4%	16.5%	16.4%
Marshall Islands				
General revenue	$103.0	$121.5	$126.2	$112.4
Revenue from local sources	47.7%	49.8%	44.0%	39.1%
Revenue from federal transfers and grants[a]	52.3%	50.2%	56.0%	60.9%
Palau				
General revenue	$46.9	$239.7	$75.7	$93.3
Revenue from local sources	34.1%	12.5%	50.9%	59.3%
Revenue from federal transfers and grants	65.9%	87.5%[b]	49.1%	40.7%
Puerto Rico				
General revenue	$9,588.2	$10,563.8	$13,174.6	$12,151.9
Revenue from local sources	72.7%	74.1%	79.8%	74.4%
Revenue from federal transfers and grants	27.3%	25.9%	20.2%	25.6%
U.S. Virgin Islands				
General revenue	$669.5	$694.1	[c]	[c]
Revenue from local sources	81.0%	83.6%	[c]	[c]
Revenue from federal transfers and grants	19.0%	16.4%	[c]	[c]

(Table notes on next page)

[2]We could not precisely determine the Federated States of Micronesia's (FSM) general revenue from federal transfers and grants because data were not available that would allow us to distinguish between transfers and grants to the national government of the FSM versus to the four FSM state governments. However, on the basis of the available data, the combined governments of the FSM are dependent for more than 50 percent of their general revenue on federal transfers and grants.

Note: Revenues of institutions of higher education were not included because complete data were not available.

[a]Interest income earned on funds in the Marshall Islands' Nuclear Claims Trust Fund and Tribunal is included.

[b]Palau received a large lump sum payment in 1995 under its Compact of Association with the United States.

[c]Data not available.

Sources: *General Purpose Financial Statements and Independent Auditors' Reports,* Commonwealth of the Northern Mariana Islands, fiscal 1994 through 1997. *Public School System, Report on the Audit of Financial Statements in Accordance with OMB Circular A-128,* Commonwealth of the Northern Mariana Islands, fiscal 1994 through 1996. *General Purpose Financial Statements, Additional Information and Independent Auditors' Reports,* Government of Guam, fiscal 1994 through 1997. *Independent Auditors' Reports, General Purpose Financial Statements and Additional Information,* National Government, Federated States of Micronesia, fiscal 1995 through 1997. (The fiscal 1994 report was not available; data for that year are from the fiscal 1995 report.) *General Purpose Financial Statements and Independent Auditors' Reports,* Republic of Palau, National Government, fiscal 1994, 1995, and 1997. (The fiscal 1996 report was not available; data for that year are from the fiscal 1997 report.) *General Purpose Financial Statements and Independent Auditors' Reports,* Republic of the Marshall Islands, fiscal 1995 through 1997. (The fiscal 1994 report was not available; data for that year are from the fiscal 1995 report.) *Comprehensive Annual Financial Reports,* Commonwealth of Puerto Rico, fiscal 1994 through 1997. *Single Audit Reports,* Government of the U.S. Virgin Islands, fiscal 1994 through 1995. U.S. Department of the Interior.

Types of federal assistance vary among the outlying areas. In our compilation of federal transfers and grants to these areas, we include all types of direct government-to-government assistance. These include (1) capital project funding and other subsidies and grants for the outlying areas, including funding for the CNMI under its Covenant in Political Union With the United States; (2) compact of association funding for the Freely Associated States; (3) federal income taxes that U.S. federal employees in Guam pay to the U.S. government that are then remitted to Guam; (4) excise taxes collected under the internal revenue laws of the United States on certain products produced in the Virgin Islands and exported to the United States (primarily rum) that are then remitted to the Virgin Islands; and (5) excise taxes on shipments of alcoholic beverages and other taxes on shipments of tobacco products from Puerto Rico to the U.S. mainland that are then remitted to Puerto Rico.[3] We did not include federal payments directly to individuals residing in the outlying areas,

[3]According to the CNMI, Guam has a significant U.S. military presence that provides additional revenue to the Guam government, which is something that the CNMI does not enjoy. For example, total wages and salaries paid to federal employees in 1997 were about $1.9 million in the CNMI compared with $359.2 million in Guam.

federal payments for services rendered, in-kind assistance, or the non-imposition of the federal income tax on residents of the U.S. territories.[4]

As table 1 above indicated, between 1994 and 1997, the CNMI government's percentage of general revenue derived from local sources was about 87 percent, while its percentage derived from the federal government was about 13 percent. The CNMI's revenue from local sources during the period from 1994 through 1997 came predominantly from the taxes it collected. As shown in table 5 in appendix I, in 1997, 70 percent of the CNMI's locally derived revenue came from taxes, while 30 percent came from licenses, fees, other charges, and miscellaneous general revenue. The largest source of tax revenue was the business gross receipts tax, which accounted for about 37 percent of all tax revenue. Wages and salary and income taxes accounted for 23 percent, while excise taxes and the customs certification user fee each accounted for 14 percent of tax revenue in 1997.

Table 2 shows that from 1994 through 1997, the revenue collection of the CNMI relative to the size of its economy was comparable to or slightly greater than that of most of the other outlying areas. We estimate that locally derived revenue as a percentage of GDP (which is commonly used to compare the revenue-raising effort, or tax effort, among countries[5]) ranged from 29 to 45 percent in the CNMI, higher than the combined ratio for all levels of government in the United States, which was 28 percent in 1996.[6] The percentages in table 2 are given as ranges if more than one estimate of GDP was available. The percentages reflect the highest and lowest estimates from all the organizations that estimated GDP for a given

[4]If the federal income tax were imposed, many residents of the U.S. territories could receive payments from the federal government because of the earned income tax credit.

[5]There are more sophisticated methods of comparing the revenue efforts of different jurisdictions. One method is the Representative Tax System (RTS), devised by the U.S. Advisory Commission on Intergovernmental Relations (ACIR) to measure the hypothetical abilities of U.S. state and local governments to raise revenue. The RTS measures revenue-raising ability by estimating the tax yield that would result from applying a standard, representative set of tax base definitions and tax rates in each jurisdiction. (See *RTS 1991: State Revenue Capacity and Effort,* ACIR, M-187, Sept. 1993, pp. 3, 6.) However, methods such as this require a considerable amount of detailed economic data, for example, data on tax bases in each jurisdiction. These data were not available for the CNMI and the other outlying areas.

[6]Because of processing and publishing lags, no published data beyond 1996 are yet available.

area and year.[7] For the CNMI for 1997, the only estimate of GDP available (made by an expert in the U.S. Bureau of the Census) is a range rather than a point estimate. He provided a range estimate because the data necessary for a more precise estimate were unavailable.[8]

Table 2: Revenue From Local Sources as a Percentage of GDP for the CNMI and Other Outlying Areas, Fiscal Years 1994 Through 1997

Year	CNMI	Guam	Federated States of Micronesia[a]	Marshall Islands	Palau	Puerto Rico	U.S. Virgin Islands
1994	36%	21%	26-33%	51-65%	16-20%	16-26%	45%
1995	31-45	22	28-35	57-64	25-28	17-26	[b]
1996	41	24-25	28-37	52-57	26-32	21-33	[b]
1997	29-34	23	35	45	35	19-27	[b]

Note: If there was more than one estimate of GDP, a range of percentages was provided.

[a]Percentages for the Federated States of Micronesia (FSM) may be slightly overstated because of a small amount of double counting when aggregating local source revenue for the FSM's national government and its four state governments.

[b]No estimate of GDP was available.

Sources: For GDP, the Central Intelligence Agency, United Nations, World Bank, International Monetary Fund (IMF), Asian Development Bank, Bank of Hawaii, Bureau of the Census, and the areas' governments. For outlying areas' revenues, the general purpose financial statements and independent auditors' reports for 1994 through 1997. Also, *Report on the Audit of Financial Statements in Accordance with OMB Circular A-133,* Chuuk State Government, Federated States of Micronesia, fiscal 1994 through 1997; *Report on the Audit of Financial Statements in Accordance with OMB Circular A-133,* State of Kosrae, Federated States of Micronesia, fiscal 1994 through 1997; *Report on the Audit of Financial Statements in Accordance with OMB Circular A-133,* State of Pohnpei, Federated States of Micronesia, fiscal 1994 through 1997; *Report on the Audit of Financial Statements in Accordance with OMB Circular A-133,* State of Yap, Federated States of Micronesia, fiscal 1994 through 1997.

[7]The economic data available for the outlying areas are limited, making it difficult to make precise estimates of GDP for those areas. Various organizations have made different estimates of GDP for the same area and year. We used all the published estimates that we found because we had no basis to determine which estimates were superior.

[8]See Marc Rubin, "National Income Accounts in the Northern Mariana Islands," *Eurasia Bulletin,* summer 1999, pp. 13-14.

Available Data Suggest That Garment Industry Taxes Are Higher in the CNMI Than in the United States, but the Burden of These Taxes Is Uncertain

The available data suggest that garment manufacturers in the CNMI pay taxes and fees that represent a higher percentage of the industry's gross receipts than do the taxes and fees paid by garment manufacturers in the United States. Although these data are incomplete for the garment industry in both the CNMI and the United States, the data represent a large enough share of all taxes and fees paid that additional data would be unlikely to change the results. However, uncertainty remains about which economic groups actually bear the burden of these taxes and fees because manufacturers may be able to shift some of the burden to others.

On average, CNMI garment manufacturers paid taxes and fees equal to about 5.0 percent of their gross receipts between 1993 and 1998. By comparison, U.S. garment manufacturers on average paid taxes and fees equal to about 3.3 percent of their gross receipts between 1991 and 1996 (the latest period for which data are available). See tables 3 and 4.

Table 3: Taxes and Fees Paid by the CNMI Garment Industry as a Percentage of Its Gross Receipts, Fiscal Years 1993 Through 1998

Dollars in millions

	1993	1994	1995	1996	1997	1998
Taxes						
User fee[a]	$8.907	$9.576	$13.897	$17.981	$27.653	$36.846
Employer's share of Social Security taxes[b]	3.611	4.399	5.002	6.330	9.873	11.037
Nonresident worker fee	0.693	0.797	1.705	1.902	2.406	3.575
Corporate income tax	0.060	0.025	0.000	0.000	0.372	0.218
Business gross receipts tax	0.044	0.049	0.011	0.572	0.360	0.500
Total taxes	**$13.315**	**$14.846**	**$20.615**	**$26.785**	**$40.664**	**$52.176**
Gross receipts[c]	$297	$319	$397	$514	$790	$1,039
Taxes as percentage of gross receipts	4.5%	4.7%	5.2%	5.2%	5.1%	5.0%

(Table notes on next page)

Note: Excise taxes paid on the garment industry's purchases, such as on construction materials, are not included in the total.

[a]The customs certification user fee was 3.0% of the value of exports to the United States in 1993-94; 3.5% from Oct. 1, 1994, to July 9, 1998; and 3.7% beginning July 10, 1998. Any inconsistency between user fees collected, the user fee rate, and gross receipts is caused by lags in reporting gross receipts.

[b]The employer's share of Social Security taxes paid directly to the federal government was estimated based on wage and salary data provided by the CNMI Department of Finance.

[c]Gross receipts figures have been rounded to the nearest million.

Sources: *CNMI August 1999 Financial and Economic Information Sheets: Highlights;* also, data provided by the CNMI Department of Finance.

Table 4: Taxes and Fees Paid by the U.S. Garment Industry as a Percentage of Its Gross Receipts, 1991 Through 1996

Dollars in millions

	1991	1992	1993	1994	1995	1996
Taxes						
Federal income tax[a]	$737	$846	$915	$978	$985	$900
Other taxes[b]	1,495	1,771	1,751	1,763	1,717	1,810
Total taxes	**$2,232**	**$2,617**	**$2,666**	**$2,741**	**$2,702**	**$2,710**
Gross receipts	$71,573	$77,332	$76,367	$80,248	$82,523	$83,384
Taxes as percentage of gross receipts	3.1%	3.4%	3.5%	3.4%	3.3%	3.3%

Note: Data are for all active U.S. garment industry corporations. Data are for corporation accounting periods ending between July of the stated year through June of the following year.

[a]Federal income tax paid, after all credits except the foreign tax credit.

[b]Taxes reported as deductions on corporate income tax returns. Included among the deductible taxes are ordinary state or local taxes paid or accrued during the year; Social Security and payroll taxes; unemployment insurance taxes; excise taxes, import and tariff duties; business, license, and privilege taxes; the environmental tax; and income and profit taxes paid to foreign countries unless claimed as a credit against income tax. Data may not include all taxes paid because some U.S. corporations include sales, excise, and related taxes that were part of the sales prices of their products in the cost of goods sold, rather than as part of a separate deduction for taxes paid.

Sources: *Statistics of Income: Corporation Source Books, Internal Revenue Service,* 1991, p. 49; 1993, p. 50; 1995, pp. 50, 529; *Statistics of Income: Corporation Income Tax Returns, Internal Revenue Service,* 1992, p. 58; 1994, p. 64; 1996, pp. 62, 199-200.

We cannot precisely compare the taxes and fees paid by garment manufacturers in the United States and the CNMI because data on taxes directly paid by those manufacturers are incomplete. For example, when paying corporate income tax, some U.S. corporations include the sales, excise, and related taxes that were part of the sales price of their products in the cost of goods sold, rather than as part of a separate deduction for taxes paid. These taxes may not be included in the statistics we have for

taxes paid.[9] These missing taxes might be paid by those manufacturers that (1) operate their own retail outlets in jurisdictions in which retailers are responsible for paying sales taxes and (2) account for their tax deduction in the manner just described. However, we believe that these missing tax payments represent a small share of the total tax payments made by the U.S. garment industry.

We do not have data on the excise taxes that CNMI garment manufacturers paid on their purchases of inputs such as construction materials. However, any excise taxes paid by the CNMI garment manufacturers would increase their taxes paid relative to taxes paid by U.S. garment manufacturers. Therefore, more complete data would be likely to continue to show that garment manufacturers in the CNMI paid taxes and fees that represent a larger share of their gross receipts than do the taxes and fees paid by garment manufacturers in the United States.

The ratios of the taxes and fees paid to the industry's gross receipts provide some perspective on the amount of revenue that the CNMI and U.S. governments are collecting through taxes directly imposed on the garment industry, controlling for the size of the industry in each location, but the ratios do not provide a very clear picture of the relative tax burdens. Determining whether garment manufacturers in either the CNMI or the United States bear a greater tax burden requires knowing what proportion of the taxes paid is shifted to other parties and then comparing the taxes actually borne by manufacturers in each location to some measure of the industry's ability to pay. We do not know what share of the reported taxes is actually borne by the industry owners. Moreover, we do not have an accurate measure of either group of garment manufacturers' ability to pay taxes. The preferred measure of the ability to pay would be net economic income. Prior studies comparing corporate tax burdens have used net income, as reported on income tax returns or in financial statements, as a proxy for net economic income. However, we did not have sufficient data from either tax returns or financial statements for CNMI garment manufacturers to estimate net economic income. The only measure available that gives even a rough sense of manufacturers' ability to pay is gross receipts. The limitation of this measure is that two businesses with the same gross receipts can have much different profit margins and, therefore, much different net incomes.

[9]See *Statistics of Income: 1996 Corporation Income Tax Returns,* Internal Revenue Service, p. 200.

There is uncertainty about which economic groups actually bear the burden of the taxes paid by the U.S. and CNMI garment industries. While remaining legally responsible for paying a tax or fee, garment manufacturers, like other businesses subject to taxation, may be able to shift some or all of the burden of a tax or fee to other groups in the economy. Such shifts would occur through changes in the prices of their products or the prices that they pay to acquire labor or materials used to make garments. (See app. II for further discussion.) The unavailability of data on supply and demand conditions in specific markets, such as the markets for garment and garment industry labor in the United States and the CNMI, prevented us from estimating the ability of the garment industry in the CNMI to shift its tax burden compared with the ability of the garment industry in the United States to do the same.

Agency Comments and Our Evaluation

The Department of the Interior raised several concerns about the data presented in this chapter. The Department questioned our inclusion of the Freely Associated States in our comparison of the fiscal self-sufficiency of the outlying areas, including the CNMI. We disagree with the Department's comment. The CNMI and the Freely Associated States have a shared history, maintain an ongoing economic and social relationship, and receive federal funds. These factors, along with congressional interest, make the comparison between the CNMI and the Freely Associated States relevant.

The Department suggested that taxes the U.S. government collects from federal employees living in Guam and remits to the Guam government, which we classified as federal transfers, should be considered as local revenue. We do not agree that federal income taxes paid by U.S. federal employees in Guam should be considered local revenues rather than federal transfers in making a fair comparison of the self-sufficiency of Guam and the CNMI. We classified federal income taxes paid by federal employees in Guam and then remitted to the government of Guam as federal transfers because this remittance is legislatively required. The CNMI has not sought similar treatment for wages and salaries paid to federal employees in the CNMI primarily because the amounts are very small. (For example, total wages and salaries paid to federal employees in the CNMI in 1997 were about $1.9 million compared with $359.2 million in Guam.)

The Department said that the CNMI's user fee on garment exports to the United States should not be counted as a local revenue source but should be considered a federal transfer resulting from the absence of import tariffs

on garments exported to the United States. We disagree. Nothing required the CNMI to impose a user fee on garment exports. Instead, the decision to apply the user fee was an autonomous act of the government of the CNMI, independent of the exemption from U.S. tariffs. Therefore, it is appropriate to include the revenue received from the user fee as local revenue when evaluating the revenue-raising effort of the CNMI.

The Department said that the taxes and fees actually borne by the CNMI garment industry are quite small. The Department also said that we should have identified which groups bear the burden of taxes. We did not address this question because data limitations prevent a reliable estimate of the extent to which specific economic groups actually bear the burden of these taxes. As agreed with the offices of the responsible congressional subcommittees, we compared the taxes and fees paid by the garment industry in the CNMI with those paid by the U.S. garment industry.

The Department said that we should exclude nonresident worker fees from our compilation of taxes and fees paid by CNMI garment manufacturers. We disagree. The fee is paid to the CNMI government by garment manufacturers who hire foreign workers and is correctly included in the total taxes and fees paid by the CNMI garment industry.

CNMI Taxes and Tax Revenue

Taxes on Business

The Commonwealth of the Northern Mariana Islands' income tax system is largely based on the U.S. Internal Revenue Code. For example, the Northern Marianas Territorial Income Tax is calculated in essentially the same manner as the U.S. income tax, with a corporate tax for those businesses that are corporations and a tax on personal income for businesses that are partnerships, family-owned, or special types of corporations.[1] The income tax base, deductions, and rates are the same under the CNMI income tax and under the U.S. Internal Revenue Code, except that the CNMI imposes tax on a few of the deductions and credits allowed under the Internal Revenue Code. Under its Covenant to Establish a Commonwealth in Political Union With the United States of America, the CNMI is authorized to rebate to taxpayers 100 percent of the income tax it collects on income sourced within the CNMI.[2] Rebate rates are identical for corporate and personal income. Rebate rates are graduated and currently range from 50 to 90 percent of the "rebate base." The rebate base is the total income tax paid on CNMI-source income minus allowed nonrefundable credits.

In addition to the income tax, the Covenant permits the CNMI to impose other taxes on businesses. These taxes include the business gross receipts tax and the customs certification user fee. Both are levied on gross receipts, the first on business receipts except those from the sale of exported goods and the second on the sale of goods exported to the United States. These local taxes may be used as nonrefundable credits against the income tax, provided the taxpayer has not used the local tax as an income tax deduction. Because these other taxes may be used as credits against the income tax, CNMI taxpayers pay only the greater of the local tax or the income tax, but not both.

The business gross receipts tax and the user fee both have gross business revenue as their base and are calculated with no deductions. The rate for

[1]The CNMI has not actually codified the Internal Revenue Code's provisions that are applicable in the Islands. Instead, the CNMI incorporated by reference the applicable provisions into its local statute and applies the Internal Revenue Code in a "mirror" fashion. That is, the CNMI utilizes the applicable Code provision by substituting nomenclature. For example, any reference in the Code to the "United States" would have "CNMI" substituted.

[2]The rebate system evolved in part because the United States wanted the CNMI to acquire, implement, and become adjusted to an established and effective tax structure. Thus, the United States required the CNMI to adopt the U.S. income tax laws. However, at the same time, it permitted the CNMI to rebate all income taxes collected to meet local policy goals.

the business gross receipts tax is graduated and currently ranges from 0 (on revenue of up to $5,000 per year) to 5 percent (on $750,001 or more). Garments that are manufactured for export to the United States are exempt from the business gross receipts tax but are instead subject to the user fee. The user fee currently is 3.7 percent of the merchandise's gross value if the CNMI must certify for the country of origin.

The CNMI imposes a general excise tax at various rates depending on the item for the privilege of first selling, using, manufacturing, leasing, or renting goods, merchandise, resources, or commodities in the CNMI for a business purpose or for personal use exceeding specified limits. Generally, the excise tax is imposed on luxury items. In addition, the CNMI imposes a nonresident worker fee on businesses that hire nonresidents as employees. The CNMI does not tax either real or personal property, and CNMI-produced goods exported to the United States generally are exempt from U.S. customs duties.

Tax Revenue

Table 5 shows the taxes collected by the CNMI government between 1994 and 1997. Table 6 shows the other types of revenue in addition to taxes that the CNMI government collected during that same period. The presentation of the CNMI government's revenue follows the U.S. Bureau of the Census's classification guidelines for the definitions of total revenue, general revenue, and local source revenue.

Table 5: Taxes Collected in the CNMI, Fiscal Years 1994 Through 1997

Dollars in millions

Tax	1994	1995	1996	1997
Business gross receipts tax	$57.6	$59.1	$67.2	$74.6
Wages and salary, and income taxes	31.0	47.4	56.3	46.6
Excise tax[a]	18.3	26.8	25.0	29.2
Customs certification user fee	9.6	13.9	18.0	27.7
Fuel tax	6.0	6.5	7.5	4.9
Beverage container tax	1.8	3.5	4.1	4.0
Hotel room occupancy tax	7.8	8.7	9.9	10.8
Developers' tax	0.4	0.7	0.6	1.0
Other taxes	2.9	3.1	2.9	3.2
Total	**$135.4**	**$169.7**	**$191.5**	**$202.0**

[a]Data on excise taxes and customs certification user fees, reported separately, are from "Financial and Economic Information Sheets: Highlights," CNMI Department of Finance, Aug. 1999.

Sources: *General Purpose Financial Statements and Independent Auditors' Reports,* Commonwealth of the Northern Mariana Islands, fiscal 1994 through 1997.

Table 6: Sources and Types of Revenue Collected in the CNMI, Fiscal Years 1994 Through 1997

Dollars in millions

Revenue source	1994	1995	1996	1997
General revenue				
Revenue from federal transfers and grants	$30.9	$39.0	$40.9	$38.9
Revenue from local sources				
Taxes	135.4	169.7	191.5	202.0
Licenses, fees, other charges, and miscellaneous general revenue	55.5	75.8	73.5	85.8
Subtotal, revenue from local sources	$190.9	$245.5	$265.0	$287.8
Subtotal, general revenue	$221.8	$284.5	$305.9	$326.7
Utility charges	48.1	[a]	54.3	60.2
Insurance trust revenue	0.1[b]	43.4[c]	61.2	99.1
Total	**$270.0**	**$327.9**	**$421.4**	**$486.0**

(Table notes on next page)

Note: Revenues of the Northern Marianas College were not included because complete data were not available.

[a]Not available.

[b]Most components not available.

[c]Some components not available.

Sources: *General Purpose Financial Statements and Independent Auditors' Reports,* Commonwealth of the Northern Mariana Islands, fiscal 1994 through 1997; *Public School System, Report on the Audit of Financial Statements in Accordance with OMB Circular A-128,* Commonwealth of the Northern Mariana Islands, fiscal 1994 through 1996; U.S. Department of the Interior.

The Potential Shifting of Garment Industry Tax Burdens

Economists recognize that the businesses or individuals that are legally responsible for paying taxes that governments impose may be able to shift some or all of their tax burden to others. Data limitations, however, often prevent a reliable estimate of the extent of this shifting. As a result, there is uncertainty about which economic groups actually bear the burden of the taxes paid by the CNMI and U.S. garment industries. Tables 3 and 4 in chapter 3 show the amounts of various taxes and fees that corporations in those industries were legally responsible for paying. However, these amounts may not represent the actual burden that the taxes and fees imposed on the shareholders of those corporations. The taxes may have altered the prices that the garment manufacturers charged for their final products or paid for their labor and other production inputs. Such price changes would have resulted in the shifting of some of the tax burden to other groups in the economy, such as consumers, workers, or the suppliers of other inputs. Conversely, the shareholders of garment manufacturers may bear some of the burden of taxes that other groups are legally responsible for paying. For example, in some situations, garment factory workers may be able to shift some of their taxes back to manufacturers in the form of higher wages. Which groups bear the burden of the taxes on garment manufacturing differs by type of tax and depends on conditions of demand and supply for inputs (such as labor and cloth) and outputs (garments). We do not have enough data on the supply and demand conditions in the CNMI and U.S. markets for garments, garment workers' labor, and so on to estimate which groups bear the burdens of the taxes imposed.

For some taxes assessed in the United States and the CNMI, there is a consensus among economists about whether businesses or other groups bear the burden. For example, economists generally believe that retail sales taxes are borne by consumers. Excise taxes also usually are assumed to be borne by consumers of the taxed products. Although excise tax revenue is collected from producers, manufacturers, or importers, the economic burden of the tax generally is passed on through higher prices to consumers. Although payroll taxes are collected from employers, they generally are assumed to be borne by workers, being passed back through lower wages. Similarly, the nonresident worker fee is likely to be passed back to labor through lower wages.

Gross receipts taxes are levied on the total receipts of a business, with no deductions permitted. In the long run, a gross receipts tax may act like a sales tax in that it may raise the prices of consumer goods. However, in the

short run, a gross receipts tax may be borne by producers.[1] In that case, the tax will be absorbed by a business's shareholders in the form of lower returns on their investment and by its workers in the form of lower wages.

There is no consensus among economists on which groups bear the tax on corporate net income. The burden may be borne by or shared by owners of the corporation, by owners of production inputs such as labor and land, or by consumers of the output produced. Some economists maintain that taxes on corporate net income have no effect on output, output price, or input prices but are reflected in lower profits, net of tax, and thus are borne by the corporation's owners, especially in the short run. There are many reasons, however, for believing that the corporate income tax can be shifted at least partly to labor inputs or to capital in general in the long run. Empirical research has been inconclusive about the extent, if any, to which shifting occurs.

[1]Producers in different industries would face different amounts of burden, depending on the degree of vertical integration in their industry.

Comments From the Commonwealth of the Northern Mariana Islands and Our Evaluation

Note: GAO's comments supplementing those in the report text appear at the end of this appendix.

The page numbers in this letter refer to a draft of this report. We have indicated page number changes for those comments that we discuss in detail.

Now GAO/RCED/GGD-00-79.

COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS

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Mr. Barry T. Hill
Associate Director, Energy
Resources, and Science Issues
United States General
Accounting Office
Washington, D.C. 20548

January 25, 2000

Dear Mr. Hill:

We have completed our review of the draft report entitled Commonwealth of the Northern Mariana Islands: Garment and Tourist Industries Play a Dominant Role in the Commonwealth's Economy (GAO/RCED/GGD-00-46).

Enclosed is a copy of our review and our comments on the draft report. Please be assured that the report and our comments have been safeguarded to prevent improper disclosure. Should you wish the return of the original draft report and the four copies we have made to facilitate review, please do not hesitate to ask.

If there is anything further my staff or I can do to assist you in your efforts please let me know.

Sincerely,

PEDRO P. TENORIO
Governor

Comments on the General Accounting Office Draft Report Entitled Commonwealth of the Northern Mariana Islands: Garment and Tourist Industries Play a Dominant Role in the Commonwealth's Economy (GAO/RCED/GGD-00-46)

General Recommendation: Place all footnotes at the bottom of the page on which they occur. Placing footnotes from page 17, for example, on to other pages breaks up continuity and is confusing in some cases.

SECTION: EXECUTIVE SUMMARY - CNMI Comments and Evaluation

Page 3, **Purpose**, line 5, add to this line, "...minimum wage, which, at *its present rate is $3.05 per hour, and the minimum wage rate is currently under review by the CNMI government.*". s
Page 4, **Background**, lines 6 and 7, "... promote political, economic, and educational advancement...". The word "educational" should be replaced with the word "*social*" which is a more accurate description of the U.S. responsibility under the Trusteeship Agreement.

Page 4, **Background**, line 7, "...advancement of the Islands' inhabitants "*leading to self government or independence*". The quote in italics is closer to the Trusteeship Agreement and makes the sentence more accurate, as well as leading into the "self-government" comment that follows in line 10.

Page 4, **Background**, line 9, "...subsistence farming and fishing, small-scale manufacturing...". There was no meaningful "small-scale manufacturing" during this time. There was significant *copra (dried coconut) production and export.*

Now on p. 7.
See comment 1.

Page 4, **Background**, second paragraph line 5, there is considerable question as to the accuracy of the population figure of "79,000" . The 1995 U.S. Census puts the figure at 69,000. The estimated population of 79,000 for the CNMI was derived from the population growth levels between the 1990 and 1995 CNMI Censuses. The growth rate, however, has changed as significant anecdotal evidence shows as a result of the Asia economic down turn. LIIDS data, school enrollment, hospital records, non-renewals of business licenses and other sources all indicate fewer people are on Saipan. This should at least be referenced. In addition, the "...and other non-U.S. citizens..." should be noted to include citizens of the Compact States who have the right , given them by the U.S. Government, to travel to and live and work in the CNMI, as well as spouses of U.S. citizens and residents who are waiting for their U.S. Green cards.

Page 5, line 4, should be amended to read, "...to garment manufacturers from *outside the U.S. Mainland*". In its present form it sounds as though the CNMI is another "nation".

Page 5, line 11, should be amended to read, "...manufacturers in the CNMI *presently* pay the...".

Page 5, line 12, the "...up to 2 percent..." should read "*...up to 5%...*", as provided by the local BGRT legislation.

Page 5, line 13, the middle sentence should be expanded to detail how much in fees are paid. There is a non resident worker application fee of $225, Health Certificate fee $20, and $25 for Non resident worker card. This revenue amounts to approximately $7,000,000 directly to the CNMI Government each year.

Page 6, line 2 should be footnoted using Footnote 26 on Page 33, otherwise this is confusing, since this is the first introduction of this reference, the proper place to footnote it first would be here, not later.

Now on p 9.
See comment 2.

Page 6, line 7, an additional sentence should be added to say that according to the U.S. Census of Outlying Areas 1995, 83% of the CNMI work force is employed in the private sector, versus 67% on Guam, and 76% in the U.S.

Now on p. 10.
See comment 3.

Page 7, **Principal Findings**, second paragraph, line 5, "...A January 1999 study..." is incorrectly dated. The correct date is "October", which is identified in Footnote 4 at the bottom of page 7.

Pages 11, 12 and 13, **Table of Contents**, page numbers need to be aligned.

SECTION: Chapter 1, INTRODUCTION - CNMI Comments and Evaluation

Page 16, lines 7 and 8, "... promote political, economic, and educational advancement...". The word "educational" should be replaced with the word "*social*" which is a more accurate description the U.S. responsibility under the Trusteeship Agreement.

Page 16, **Background**, line 12, "...subsistence farming and fishing, small-scale manufacturing...". There was no meaningful "small-scale manufacturing" during this time. There was significant *copra (dried coconut) production and export..*

Page 17, Footnote 14, might better read, "Some came from the former *districts of the Trust Territory, namely* the Federated States of Micronesia..."

See comment 1.

Page 17 bottom and 18 top, as noted previously, "...and other non-U.S. citizens..." should be noted to included citizens of the Compact States who have the right, given to them by the U.S. Government, to travel to and live in the CNMI, as well spouses of U.S. citizens who are waiting for their U.S. Green cards. These two groups are a significant contribution to the "non-U.S. citizens" work force numbers.

Page 18, bottom paragraph, line 6, change 2 percent to "*5 percent*".

SECTION: Chapter 2, THE IMPACT - CNMI Comments and Evaluation

Now on p. 22.
See comment 4.

Page 19, Footnote 16, should note that Guam has a significant U.S. military presence which provides approximately $17,000 for every person on Guam in revenue to the Guam government, something the CNMI does not enjoy.

Now on p. 23.
See comment 5.

Page 20, end of last sentence, should note that mandated additional benefits e.g. health insurance and transportation, under local law for contract workers tended to hold down the cash wage for them, while local workers cash wage went up to compensate for the lack of these benefits.

Now on p. 24.
See comment 5.

Page 21, end of line 5, should add a sentence to say that, "*It should be noted that CNMI law requires employers to provide to non resident workers free health insurance and transportation to and from the CNMI, and in some cases food, housing and clothing* ".

Page 22, "Source" under the chart, should note that this is "*Draft 1*".

Now on p. 25.
See comment 6.

Page 22, line 4, should include a reference to the fact that a large number of garments are exported with a "Made in the Commonwealth of the Northern Mariana Islands" label and not "Made in the U.S.A.".

Now on p. 26.
See comment 7.

Page 22, bottom to page 23 top, should note that it was the Federal Government responsibility to enforce federal laws during this time not the CNMI.

Now on p. 26.
See comment 8.

Page 23, lines 4 through 8, are not factual but allegations taken from the media. It was our understanding that the GAO Report would not include negative unproved, non factual allegations and related material from media sources. We hope you will consider removing or modifying these lines.

Page 29, line 6, incorrectly footnotes the June 1999 study, which is incorrectly dated. It should be the January 1999 study identified on page 33 as Footnote 26. It should also be footnoted in its own right on page 29.

Page 30, last line, should read, ..."production has *mitigated the impact of the current economic downturn caused by the recession in Japan and other Asian countries*".

Page 31, line 2, the number in "...it was 2 years ago...", should be spelled out as two.

Now on p. 36.
See comment 9.

Page 31, lines 5 and 6 note that U.S. citizen rate of unemployment on Saipan is about 13% (approximately 1,400 residents) as of the 1st Quarter 1999 Statistics Report of the CNMI Department of Commerce. In the interests of fairness and objectivity, and for comparison purposes, Guam - which has U.S. Immigration and U.S. Minimum Wage - should be identified as having an unemployment rate of about 12.9% (about 7,300 residents) as published by the Guam Bureau of Planning, 1st Quarter, 1999. The point is that the primary reason for the high unemployment rate in Guam and the CNMI is not U.S. Minimum Wage or U.S. Immigration, but the economic recession in Asia.

Page 32, first full paragraph, line 9, same comment about spelling out 2 as above.

Now on p. 38.
See comment 10.

Page 34, lines 1 through 4, it should be noted here that unlike the non resident workers who have paid employer health insurance, people from the Compact States who come to Saipan in significant numbers to live and work, do not have this benefit and are thus a heavy burden on the CNMI Government which must pay their health service costs and education costs and other types of services, and for which the Government has not been reimbursed as required in the form of Compact Impact funding. This also exacerbates the deficit problem. It should also be stated that Guam receives Compact Impact aid, even though the CNMI is included in the legislation under which Guam receives the aid.

Now on p. 39.
See comment11.
Now on p. 44.
See comment 12.

Page 34, last paragraph, line 8, the last number we have is 1,400 as noted above.

Page 39, last paragraph, lines 3 and 4, notes that "...Many garment factories in the CNMI are owned by Chinese companies..." Since the total number of garment factories was identified earlier as 34 on page 30, why not give a specific number owned by Chinese companies. It should also be noted that garment factories producing the majority of garments in the CNMI are owned by U.S. citizens.

SECTION: Chapter 3, CNMI GOVERNMENT'S - CNMI Comments and Evaluation

Now on p. 46.
See comment 13.

Page 41, last paragraph, should reference that without Compact Impact aid, the cost of approximately $13.7 million in FY '97 and $15.1 million in FY '98 for providing services to citizens of the Compact States is completely borne by the CNMI Government, thus aggravating the deficit problem.

Now on p. 46.
See comment 14.

Page 41, last paragraph, should note that the CNMI is faced with the problem of providing full government services to three islands in the form of police, utilities, air and sea ports, education, health, roads and so on, in the face of a declining economy and no support from the Federal Government in the form of Compact Impact aid although Guam receives such aid.

Page 44, first paragraph, line 4, "...As shown in table I.1 in appendix I..." Should probably read, "...As shown in *Table* I.1 in *Appendix* 1...".

Page 48, first paragraph, line 9, there is an extra space after "...manufacturers'...".

SECTION: APPENDIX I, CNMI TAXES - CNMI Comments and Evaluation

None

SECTION: Appendix II, THE POTENTIAL SHIFTING - CNMI Comments and Evaluation

Page 52, first paragraph, line 5, the word "chapter" should probably be capitalized since it is specific as in "Chapter 3".

GAO Comments

The following are our comments on the Commonwealth of the Northern Mariana Islands' letter dated January 25, 2000. The Commonwealth provided clarifications and technical points that were incorporated into the report as appropriate.

1. We added the suggested caveat about the 1999 population figure (see footnote 2, executive summary) and added that some of the non-U.S. citizens are from the Freely Associated States or are immediate relatives of U.S. citizens (see footnote 3, executive summary).

2. While we do not dispute the figures the Governor's Office provides, we believe the comparison between the percentages of workers employed by the private sectors in Guam and the United States with the percentage employed by the private sector in the CNMI could be misleading because the CNMI workforce includes a large proportion of foreign workers who temporarily reside in the CNMI and are primarily employed in the private sector. Guam and the United States do not have similar proportions of foreign workers in their total workforces. While the percentage of total workers employed by the CNMI government may be relatively low, the percentage of the U.S. citizen population employed by the government is much higher.

3. The January 1999 study is correctly identified.

4. We added some suggested language regarding the large U.S. military presence in Guam. See footnote 3, chapter 3.

5. We do not think there is empirical support for the claim that mandated additional benefits to foreign workers hold down their wages or that the lack of similar benefits cause local wages to rise. While foreign workers do often receive these additional benefits, it is also the case that employers can legally deduct some money from these workers' wages. We believe there are insufficient data on the actual value of benefits received by all workers or on the deductions to foreign workers' wages to assess the net value of these benefits.

6. The context of the discussion pertains to a controversy over garments that are labeled as "Made in the U.S.A." and not over those labeled as "Made in the Commonwealth of the Northern Mariana Islands."

7. The issue concerns violations of federal wage and labor laws regardless of who has the enforcement responsibility.

8. The report properly attributes the source of the information to the print and broadcast media.

9. The report does not attempt to explain the rate of unemployment among local residents or U.S. citizens in the CNMI because we do not believe there is enough information about the causes of unemployment in the CNMI to do so. We have added the views of the CNMI and the Department of the Interior on this issue to the report (see footnote 2, chapter 2). The number of unemployed local residents that we cite in the report as 1,800 includes about 1,400 unemployed U.S. citizens and about 400 permanent residents of Saipan who are not U.S. citizens.

10. The discussion in this section is designed simply to show that the CNMI's population of local residents is insufficient to supply enough labor for an economy of the size and scope of the CNMI's. The report does not measure the fiscal impacts of particular groups.

11. The number of unemployed local residents that we cite in the report as 1,800 includes about 1,400 unemployed U.S. citizens and about 400 permanent residents of Saipan who are not U.S. citizens.

12. The report describes the potential outcome if China were to become a member of the WTO. The impact on the garment industry does not necessarily depend on how many Chinese- or U.S.-owned garment factories there are in the CNMI.

13. This report does not specifically address the causes of the government's deficit. We discuss the relative size of federal spending on wages and salaries in Guam and the CNMI in footnote 3, chapter 3.

14. We have added text to chapter 2 noting the concerns of the CNMI that it is faced with the problem of providing government services for three islands despite a declining economy and without receiving Compact Impact Aid.

Comments From the Department of the Interior and Our Evaluation

Note: GAO's comments supplementing those in the report text appear at the end of this appendix.

United States Department of the Interior

OFFICE OF THE SECRETARY
Washington, D.C. 20240

FEB 1 2000

Mr. Barry Hill
Associate Director
Resources and Science Issues
US General Accounting Office
441 G Street, NW, Rm. 2928
Washington, DC 20548

Dear Mr. Hill:

I am enclosing the comments of the Department of the Interior on the GAO Draft Report: Northern Mariana Islands; Garment and Tourist Industries Play a Dominant Role in the Commonwealth's Economy. I request that these comments be included with the final GAO report and hope that they will be of use in revising conclusions for the final version of the report.

Our view is that the economic analysis, which is the basis of the report is seriously flawed. While the draft report accurately depicts the dominant role of the garment and tourist industries, it fails to evaluate the effect of these industries and their alien employees on the United States citizen residents of the Northern Mariana Islands and on the economic development of the Commonwealth. The draft report also compares revenue raising efforts of the CNMI and other insular areas and compares taxes paid by the garment industry in the CNMI and the industry in the United States. Because the comparisons do not include equivalent items on both sides, they are seriously distorted.

Thank you for the opportunity to comment on the draft report.

Sincerely,

John Berry
Assistant Secretary
Policy, Management and Budget

Enclosure

**Comments of the Department of the Interior
on the draft GAO report:
Garment and Tourist Industries Play a Dominant Role
in the Commonwealth's Economy**

See comment 1.

The draft GAO report seeks to answer three questions regarding the economy of the CNMI. The general intent of the three questions appears to be to gain a better understanding of the degree to which the CNMI economy, particularly its garment industry and its use of non-resident alien workers, contribute to the well-being of its people and the fiscal needs of its government. The specific questions were decided upon by the GAO following discussions with staff of responsible congressional committees. The draft report seeks to answer these questions narrowly, without reference to the economic, legal, and regulatory context in which the CNMI economy operates. The result is a report containing data and observations that are factually based but often out of context, incorrectly categorized and misleading.

See comment 2.

A major difficulty in describing the CNMI economy is that, unlike any other region of the United States, it consists primarily of an enclave of non-resident alien workers and employers whose links to the Commonwealth's citizens consist mainly of indirect employment of government workers. As a result, a simple description of the CNMI's major industries ignores the effect of their development on the population and institutions of the Commonwealth.

See comment 3.

The draft report also deals with two related questions regarding CNMI revenue raising effort and comparative taxation of CNMI and U.S. garment industries. Here, the report has, perhaps inadvertently, used definitions and interpretations of data that lead to greatly distorted and inaccurate comparisons.

The first, and fundamental, questions dealt with by the report is:

What has been the impact of the garment and tourist industries and the use of foreign workers on the economy of the CNMI?

See comment 4.

The draft report answers this question by stating the obvious, that "The garment and tourist industries play a dominant role in the Commonwealth's economy". We do not question this conclusion, nor do we question the ensuing description of the success of these two industries, which have grown rapidly in both employment and income, notwithstanding a recent decline in tourism. The draft report accepts without question the definition of the CNMI economy as composed of alien workers, alien based industry, and indigenous workers dependent on government employment without raising the fundamental question of the appropriateness of such an economy in the context of American tradition, values and laws. The economy of the CNMI is described in reports by the Bank of Hawaii as a "two-tiered economy" in which the garment industry, parts of the tourist industry, and those directly associated with them, benefit, while the foundations of economic growth, including employment and training of local residents, fall behind. Our concern is that the GAO report may be utilized as an economic evaluation of this enclave-based economy or, worse, as a prescription for continuation and growth of an economy

dependent on non-resident alien employment. An economy whose principal industry grows by 30 percent annually while its government deficit increases and its citizens endure increased unemployment deserves a more thorough analysis, one that would ask and seek to answer basic questions of economic analysis: What are the long term benefits of existing or planned industries to the economy? What are the effects in training and employment of citizens? What are the alternatives to the current economic system? Unfortunately, concepts such as comparative advantage, opportunity costs, long-term viability of industries, and employment and training of citizens are outside the scope of this report.

See comment 5.

The draft report cites a 1999 economic report to show that the benefits of these industries and workers are not limited to them but that, "their growth has caused development of other businesses and contributed to the growth of the government sector." But how much has the growth of these other business and the government sector contributed to the long-term well being of the CNMI's citizens? The cited economic report calculates that the garment industry has an employment multiplier of about 1.5, meaning that each job in the garment industry generates one-half job in the rest of the economy. It is worth noting that a multiplier of 1.5 is lower than that of the garment industry of any other country and lower than that of any other industry, current or contemplated, in the CNMI. Furthermore, the 1999 report showed that in 1995 the garment industry employed 7,200 non-resident aliens and generated a total of 1,270 private sector jobs in all industries for residents. Thus the garment industry employment multiplier for private sector jobs for locals was about 1.165. Since 1995, the number of alien garments workers has nearly doubled while employment of residents has grown little. This means that the private sector employment impact of the garment industry is roughly one local worker for each 10 alien workers. In order to absorb a modest growth rate of 3 percent in the local labor force, the garment industry would have to grow at about 30 percent annually indefinitely, a rate that is neither possible nor advocated by anyone in the CNMI. (In fact garments did grow at 30 percent from 1995 to1998, bit with an attendant increase in local unemployment and the government deficit.). This is why, like Alice in Wonderland, the CNMI economy has to run very fast in order to stand still.

See comment 6.

By combining self-evident and misleading statements, the draft report creates an inaccurate picture. It states the obvious fact that, "The labor pool of local residents, even including those currently unemployed, is insufficient to provide labor for the CNMI economy." It also makes the misleading statement: "All sectors of the economy, including the government sector, hire foreign workers". These statements give the impression that the CNMI is a melting pot in which non-residents and citizens work side-by-side for the greater good of all. Nothing could be further from the truth. In fact, more than 90 percent of private sector employment is of non-citizens (a small number of whom are Micronesians) and nearly 90 percent of government employment is of U.S. citizens (the aliens being concentrated in teaching and health care).

See comment 6.

The Bank of Hawaii describes an economy that shifts income from low income private sector non-resident workers to high income public sector resident workers. Its "Economic Report October 1999" on the Northern Mariana Islands states, "Assuming the household income numbers are accurate, they show that the average standard of living on Saipan, as measured by either the median or mean income, was lower in 1999 than in 1990, in spite of more employees

on payroll and more taxes to the CNMI treasury". The reason for this discrepancy is that the economy is based on transfers of wealth from low-wage alien workers to high-wage indigenous government workers. As the Bank of Hawaii puts it; "Existing evidence suggests that this alien labor has not only skewed Saipan's wage and income data toward the lower end of the income scale but also changed income distribution in favor of the affluent".

See comment 7.

Within the private sector, there are also an important distinctions, absent from the draft report, between the two dominant industries, garment assembly and tourism. Garments employ almost exclusively non-resident aliens. Few U. S. citizens will work at a sewing machine in a garment factory. They don't have the skills and they will not work for wages as low as the minimum in the CNMI. In tourism, however, while aliens comprise the majority of the work force, all jobs are open to local residents and are often attractive to them, due to their higher wages and chance for advancement. A large proportion of tourism employment in Guam and other parts of the United States is comprised of recent immigrants, but they are resident immigrants who enjoy the rights of other residents and have a stake in the community, instead of remaining outsiders and sending most of their income abroad.

See comment 8.

An equally important difference between the two industries is in their long-term viability. The tourist industry makes use of the CNMI's primary natural resources--attractive environment and proximity to tourist markets. As this industry develops a reputation as a first-class destination resort, it is likely to prosper. In contrast, the garment industry makes use of no local resource, and in fact devalues the primary attribute that supports tourism, a clean and attractive environment. The garment industry exploits an artificial and temporary provision in the international trade regime which permits it to produce profitably a product in which it has no natural competitive advantage. The CNMI has used a hiatus in the application of the U.S. immigration and minimum wage laws and an exemption from United States tariffs and quotas to assemble Chinese garments for the United States market. The draft report recognizes, but understates, the implications of this when it states that "changes that reduced or eliminated the advantages of manufacturing garments in the CNMI might cause some or all of the CNMI garment industry to relocate to other countries,". Under agreement of the World Trade Organization, United States garment quotas will cease on January 1, 2005, and this artificial advantage enjoyed by the CNMI will come to an end. Because the draft report is not oriented toward the future, even the short-term future, it ignores the obvious danger of over-dependence on an industry that is not merely uncertain but scheduled to cease abruptly in five years' time.

See comment 9.

The draft report questions the conclusions of a 1999 Fiscal Impact Report prepared for the Office of Insular Affairs that the costs of alien workers in the CNMI exceed their benefits to the economy. However, it does not offer an alternative analysis nor does it offer an explanation of how growth in the alien labor based economy can lead to increased fiscal deficits and unemployment of citizens, as it has in the CNMI. (It might be useful if the draft report were made available to the authors of the fiscal impact report for comment).

See comment 10.

Another critical issue ignored by the draft report is the economic effect of the increase in the population of dependent children of aliens. Since 1991, the number of births to alien mothers has surpassed births to U. S. citizen mothers. Because these children are still young, most of

them have not yet entered school, nor have they reached the critical years in which they can become productive members of the society or problems for it. In either case, they will create a substantial cost to be borne by both the local and federal governments in education, law enforcement, welfare and other services.

The second question dealt with in the report is:

How do the revenue-raising efforts of the CNMI and the payments that the CNMI receives from the U.S. Treasury compare with those of other U.S. territories and Freely Associated States?

See comment 11.

The draft report concludes that the CNMI is more self-sufficient fiscally than other U.S. outlying areas. We believe that a critical examination of the data would not support this conclusion. First, we question the inclusion of the freely associated states of the Marshall Islands, Federated States of Micronesia and Palau as U.S. outlying areas. These areas are not part of the United States and are not outlying areas as that term is used by the Census Bureau or other federal agencies and their relationship to the United States and economic circumstances are fundamentally different from the CNMI. The freely associate states are the recipients of massive federal assistance under the Compacts of Free Association and, except for Palau, have very little local economic activity or locally generated revenues. Their inclusion, therefore, substantially distorts a comparison with the CNMI. It is worth noting that the CNMI was similarly dependent of federal budgetary assistance during the early years of its commonwealth status.

See comment 12.

Comparison with other outlying areas of the United States, particularly nearby Guam, is appropriate but difficult, as sources of information on federal grants are often conflicting. This part of the report appears to represent a good effort to sort out these data; however, a critical evaluation would be easier if the sources and amounts of federal transfers and grants were included.

See comment 13.

We suggest that the draft report's treatment of local revenues of Guam should be modified to include income taxes paid by military and other federal personnel on Guam. In all the insular areas, income taxes are paid into the local treasuries rather than to the Federal Government. Thus in the CNMI, the federal income tax liability of all taxpayers, including most federal employees, is satisfied by payment to the Commonwealth Government. In accordance with this principle, military and civilian federal personnel stationed on Guam satisfy their income tax obligation by payment to the Federal Government, which then transfers those payments to the Government of Guam. These collections, totaling $37 million in 1997, should be removed from the category of federal transfers and grants and treated as revenue from local sources.

See comment 14.

There is a conceptual issue with the CNMI tax data as well. As noted in the report, the principal payment by the garment industry to the local government is the "user fee", or export fee of $36.8 million in 1998. This fee is levied at 3.7 percent of 1998 garment shipments of approximately $1 billion. (We note that table 3.3 shows 1998 garment industry gross receipts as $834 million and user fee of $38.8 million; this comes to 4.4 percent of gross receipts rather than the 3.5 percent

and 3.7 percent rates that were actually in effect in 1998: this error may be due to leads and lags in the data.) While the user fee is nominally a local tax payment, economically, it is identical to a tariff on imports into the United States. In effect, the Federal Government provides a tariff subsidy of 21 percent to the CNMI garment industry, 3.7 percent of which is a federal transfer to the CNMI treasury, while the remainder serves as a transfer to the CNMI garment industry. With these corrections to local revenue and federal transfers for Guam and the CNMI the comparison would show that the CNMI's revenue from local sources is a lower percentage than that of Guam, and that the CNMI is less self-sufficient fiscally than Guam.

The final question dealt with by the GAO report is:

How do the taxes and fees paid by the garment industry in the CNMI, expressed as a percentage of gross receipts, compare with the taxes and fees paid by the garment industry in the United States?

See comment 15.

The draft GAO report includes important caveats, in Appendix II, regarding the potential shifting of garment industry tax burdens. Essentially, the appendix states that it is very difficult to tell whether producers, consumers or employees actually bear the tax burden in view of the shifting of the incidence of taxes on business. The great majority of the taxes shown as paid by the CNMI garment industry are in the form of the user fee, or export tax. As we have noted above, this export tax is economically similar to the import tariff, which it partially replaces. CNMI garments are imports into the United States, exempt from an average 21 percent tariff, but subject instead to a 3.7 percent export tax in the place of origin. Thus the user fee is borne in the same way as the tariff on imported garments, by the importer, distributer, or consumer, not the producer. There is no reason to include this fee in a comparison of taxes paid by U.S. and CNMI garment industries.

See comment 16.

The second largest tax on the CNMI industry listed by the draft report is the employer's share of social security taxes. The social security tax is a payroll tax, about which the draft report's appendix states: "Although payroll taxes are collected from employers, they generally are assumed to be borne by workers, being passed back through lower wages". In other words the CNMI industry's payment of social security taxes should not be considered part of its tax burden. The third largest item in the list of taxes paid by the CNMI garment industry is the nonresident worker fee; this is a fee collected by the CNMI government to offset part of its costs in processing and caring for alien workers. A comparable fee for domestic industry does not exist, but it is economically similar to a fee paid to employment services or other similar cost of doing business. This fee, as well, is inappropriate in a comparison of tax burdens.

See comment 17.

After deducting the user fee, social security tax, and nonresident worker fee from the list of taxes paid by the CNMI garment industry, the only remaining taxes are income tax and business gross receipts tax. The total of these two taxes is $0.718 million in 1998. As a percent of gross receipts, this is 0.086 percent in 1998. Thus the data suggest that the taxes actually borne by the garment industry in the CNMI may be less than one tenth of one percent of its gross receipts.

See comment 18.

In summary, we do not question the draft report's title statement that garment and tourist industries play a dominant role in the Commonwealth's economy, nor do we doubt that both industries contribute to the CNMI economy. However, in accepting the soundness of an economy based on non-resident alien labor and government employment, the report gives the erroneous impression that this type of economic growth is beneficial in the long run. We regret that the report was unable to examine the CNMI economy as a whole and to comment on the implications for the future course of its development, although we realize that such a report would be beyond the scope of work and the resources that were provided to the GAO team.

Office of Insular Affairs
January 31, 2000

GAO's Comments

The following are our comments on the Department of the Interior's letter dated February 1, 2000. The Department provided clarifications and technical points that were incorporated into the report as appropriate.

1. We do not agree that the report answers these questions narrowly or without reference to economic, legal, and regulatory context. We also do not agree that the data and observations in the report are taken out of context, incorrectly categorized, and misleading. The report describes in detail the historical, economic, legal, and regulatory context in which the CNMI economy currently operates. Specifically, it explains the context in which the garment industry in the CNMI has come into being along with the use of foreign workers. It also enumerates a number of concerns expressed by some about violations of existing labor and worker safety laws and the fiscal impact of the garment industry on the government of the CNMI. In addition, it discusses the relationship between the United States and the Northern Mariana Islands, both before and after the Commonwealth was formed. In this context, the report discusses key provisions of the Covenant establishing the CNMI that affect wages, exports, immigration, and taxes. The report also presents an objective description of the controversies surrounding the use of foreign workers and the garment industry. Furthermore, the report uses data and information from a wide range of sources and presents the results in a balanced, fact-based, and objective manner.

2. We disagree. The report provides more than a simple description of the CNMI's major industries and does not ignore the effect of the industries' development on the population. The report explains how local residents, most of whom are U.S. citizens, have benefited from economic growth. We define local residents as the combination of U.S. citizens and citizens of the Freely Associated States of the Republic of the Marshall Islands, the Federated States of Micronesia, and the Republic of Palau because citizens of the Freely Associated States have the legal right of residency in the CNMI. Whenever data were available to do so, we make the distinction between local residents and foreign workers. In other cases we distinguish between U.S. and non-U.S. citizens. For example, figure 2 distinguishes between U.S. and non-U.S. citizens in the population, figures 4 and 5 show average wages of workers born in the CNMI and workers born in Asia, figure 7 isolates local residents as a component of the total labor force, and figure 8 shows the occupations of workers and distinguishes between those born in the CNMI, the Philippines, and China.

3. We disagree that our definition and interpretation of the data generate distorted and inaccurate comparisons. Although the data we used to answer the questions on the CNMI's revenue-raising effort and the comparative taxation of the garment industries of the CNMI and the United States have limitations, we discussed these limitations with the offices of the responsible congressional subcommittees and described them in various places throughout the report. We used the best sources of data available to address the questions that we were asked, and we believe that the comparisons we present, with the accompanying caveats, are as accurate as possible.

4. We agree that the report does not address the question of the appropriateness of the CNMI economy in the context of traditional American values and laws. It was beyond the scope of our objectives to address potential alternatives to the CNMI's current economy. We do not agree with the Department's statement that the foundations of economic growth, including employment of local residents, have fallen behind. For example, we point out that the number of jobs held by U.S. citizens has grown faster than the population of U.S. citizens, while labor participation rates increased for U.S. citizens in the period between 1980 and 1999. In addition, a larger proportion of U.S. citizens became self-employed over that period. Finally, a bigger proportion of U.S. citizens work in the private sector now than in 1980, despite the rapid growth in government employment.

We agree that the high rate of unemployment among U.S. citizens is an area for concern as is the CNMI's budget deficit. However, we disagree that the garment and tourist industries or the foreign workers are the causes of these problems. We found no data that support the claim that unemployment in the CNMI is caused by the garment and tourist industries or by their use of foreign labor. On the contrary, we agree with the October 1999 report prepared under the supervision of Northern Marianas College with funding from the Department, which states that the garment and tourist industries are the source of most of the CNMI's economic activity, including exports, employment, and production of goods and services. We did not determine the cause of the high rate of unemployment among U.S. citizens, but we added the views of the Department and the CNMI government to the report (see footnote 2, chapter 2).

We agree with the Department that the long-term prospects for the CNMI economy are also a concern. The report states that the CNMI's reliance on these two industries and on foreign labor for much of its workforce makes

the economy vulnerable to outside events. Specifically, we say that changes in the Asian economy that affect tourism, potential legislation changing the CNMI's immigration policy, and the potential for changes in international trade agreements that might cause all or part of the garment industry to leave the CNMI would all have a major impact on its economy.

5. We agree with the Department that the multipliers for the CNMI garment industry are low compared with garment industries in other countries and, as we stated in comment 4, that high unemployment rates among U.S. citizens and the budget deficit are problematic. We did not determine the cause of the high rate of unemployment among U.S. citizens, but we added the views of the Department and the CNMI government to the report (see footnote 2, chapter 2).

We do not agree that private sector employment for local workers has grown little since 1995. For example, according to data from the CNMI Department of Commerce, private sector employment of U.S. citizens increased by about 24 percent between 1995 and 1999 on Saipan, while total employment of U.S. citizens, including employment in the government sector, rose by about 22 percent. Employment of non-U.S. citizens increased by about 43 percent over the same period, but this includes about a 27-percent increase in employment of people born in the Freely Associated States, who are not considered foreign workers.

Furthermore, the numbers that the Department presents and its use of multipliers may be misleading. The Saipan economy added about 2,100 jobs for local residents, including about 1,650 jobs for U.S. citizens and 450 jobs for workers born in Micronesia. During the same period, the economy added about 10,000 new jobs for foreign workers. In other words, the economy added almost 2 jobs for local residents for every 10 jobs it added for foreign workers, about twice what the Department claims. The growth in employment for U.S. citizens from 1995 to 1999 occurred even though the economy suffered a 30-percent decline from 1997 levels in visitors in 1998 and 1999.

6. We do not intend to give the impression that the CNMI is a melting pot in the sense commonly used to describe the United States. Foreign workers send much of their incomes back to support their families in their home countries. Nonetheless, the CNMI does not have sufficient labor and skills to have developed as it has without access to foreign workers, and all sectors of the CNMI economy rely on foreign workers.

We do not agree with the Department's implication that the economic advances of local residents come at the cost of transferring wealth from foreign workers. While it is true that foreign workers earn lower wages than do local resident workers–we point this out in figures 4 and 5 of our report and in the accompanying text–it is also true that for foreign workers born in Asia, wages have risen since 1980 and that in 1999, these workers' average wages were $5.33 per hour. Moreover, average wages of workers born in Asia in every major occupational category except "farming, forestry, and fishing" (in which only 76 people were employed in 1999) were higher than the CNMI's minimum wage of $3.05 per hour. Finally, foreign workers come to the CNMI voluntarily to work, and the Philippine Consul told us that the CNMI is a destination of choice for workers from her country, in part because wages in the CNMI for foreign workers are much higher than wages in the Philippines. The minimum wage in the Philippines is about $1.00 per day, compared with $3.05 per hour–or $24.40 per 8-hour day–in the CNMI.

We do not agree that the distribution of income in the CNMI has changed in favor of the affluent. As discussed in the report, the distribution of income was flatter in 1999 than in 1980. Median household incomes of local residents have increased–in particular, Chamorro household income rose from about $8,900 per year in 1980 to about $30,700 in 1999.

7. The data collected by the CNMI government are not sufficiently detailed to evaluate the Department's claim that jobs in the tourist industry are inherently more attractive than jobs in the garment industry. The data on employment do show that on Saipan in 1999, about 900 workers born in the CNMI (and who were therefore U.S. citizens) worked as operators, fabricators, and laborers–the occupational category that employs about 86 percent of Chinese workers, most of whom work in the garment industry. About 2,000 workers born in the CNMI worked in managerial and professional specialties, and about 2,000 worked in technical, sales, and administrative support positions. However, for these 4,000 U.S. citizens, the data do not distinguish whether they work in the garment or tourist industry or elsewhere.

We do not disagree that a large proportion of tourism employees in Guam and the United States may be recent immigrants or that, as resident immigrants, these workers have a bigger stake in their communities than do temporary resident workers. As stated, in chapter 2 of our report, foreign workers in the CNMI send much of their earnings back to their countries of origin.

8. We disagree that the garment industry in the CNMI will necessarily cease in 5 years' time. The advantages that the CNMI garment industry have over many of its international competitors are three-fold: (1) They can sell their products to buyers in the United States without import tariffs. (2) The products are not subject to U.S. import quotas. (3) The products can bear labels identifying them as being made in the United States. Even if quotas are eliminated as scheduled, the tariff and labeling advantages will remain largely intact, and whether garment production will leave the CNMI for other WTO members in 2005 and beyond will depend on whether the value of the benefits received from the tariff-free status and the identification of products as having been made in the United States offset the higher wages paid in the CNMI.

9. We disagree that the growth in the economy based on alien labor has led to increased fiscal deficits. On the contrary, we found that a study prepared for the Office of Insular Affairs that concluded that alien workers had a negative fiscal impact on the CNMI government was methodologically flawed. We also disagree that the growth of the economy has led to increased unemployment as discussed in comment 4.

We agree that our report does not offer a complete alternative analysis to the 1999 *Fiscal Impact Report.* We believe, however, our report offers detailed, factual examples indicating that foreign workers have a smaller fiscal impact than do local residents. It also points out that the 1999 *Fiscal Impact Report* understates the contributions of the garment and tourist industries to the CNMI economy and provides specific examples of the types of contributions that were not taken into account in the 1999 *Fiscal Impact Report.*

10. We added text to include the information provided by the Department that since 1991, the births in the CNMI to mothers who were not U.S. citizens have been greater than births to mothers who were U.S. citizens. We also added information showing that the birth rate for women between the ages of 15 and 45 is much lower for non-U.S. citizens than for U.S. citizens and discussed the implications of this on the fiscal impact of foreign workers.

11. We disagree that the inclusion of the Freely Associated States of the Marshall Islands, the Federated States of Micronesia, and Palau distorts a comparison with the CNMI. These countries have a shared history with the CNMI as part of the former Trust Territory of the Pacific Islands and have an ongoing economic and social relationship—citizens of the Freely

Associated States have the right of residency and employment in the CNMI, and many have come to the CNMI to live and work. In addition, the Freely Associated States and the CNMI receive federal funds. Finally, as the Department has pointed out, the CNMI was similarly dependent on federal budget assistance during the early years of its commonwealth status. These factors, along with congressional interest, make the comparison between the CNMI and the Freely Associated States relevant. To ensure that the low level of economic activity in the Marshall Islands and the Federated States of Micronesia does not distort the comparison, we present data showing the percentage of local source revenue as a proportion of GDP—if local source revenue is low because local economic activity is small, then the ratio of the two is a way to control for the size of the economy.

12. We added text clarifying that we included annual Covenant funding from the Department of the Interior in calculating federal transfers to the CNMI. For more details on the amounts and types of federal transfers and grants to the CNMI and Guam, see, for example, *General Purpose Financial Statements and Independent Auditors' Report,* Commonwealth of the Northern Mariana Islands, fiscal 1997 (pp. 55, 61), and *General Purpose Financial Statements, Additional Information and Independent Auditors' Report,* Government of Guam, fiscal 1997 (pp. 53, 67-71, 73, 75, 84, 94-95).

13. We do not agree that federal income taxes paid by U.S. federal employees in Guam should be considered local revenues rather than federal transfers in making a fair comparison of the self-sufficiency of Guam and the CNMI. We classified federal income taxes paid by federal employees in Guam and then remitted to the government of Guam as federal transfers because this remittance is legislatively required. The CNMI has not sought similar treatment for wages and salaries paid to federal employees in the CNMI primarily because the amounts are very small. (For example, total wages and salaries paid to federal employees in 1997 were about $1.9 million in the CNMI compared with $359.2 million in Guam.)

14. We changed our source of data on gross receipts for the CNMI garment industry for 1997 and 1998 to make it consistent with the data that we used in previous years. This change resulted in a small reduction in the ratio of taxes to gross receipts for the CNMI garment industry for those 2 years. We also added a note to table 3 that acknowledges possible lags in reporting gross receipts.

However, we do not agree with the Department that the revenue that the CNMI receives from the user fee on garment exports to the United States should be considered as a federal transfer because nothing required the CNMI to impose a user fee on garment exports. Instead, the decision to apply the user fee was an autonomous act of the government of the CNMI, independent of the exemption from U.S. tariffs. Therefore, it is appropriate to include the revenue received from the user fee as local revenue when evaluating the revenue-raising effort of the CNMI.

15. We disagree that the CNMI's user fee should be excluded from the comparison between taxes paid by the garment industry in the CNMI and taxes paid by the garment industry in the United States as explained in comment 14. We did not address the question of whether the taxes and fees actually borne by the CNMI garment industry are nearly negligible and lower than those borne by the U.S. garment industry. We compared the taxes and fees paid by the garment industry in the CNMI, expressed as a percentage of gross receipts, with the taxes and fees paid by the U.S. garment industry. In our report, we state that one limitation to this approach in evaluating the relative tax burden of the garment industry in the CNMI and in the United States is that there is uncertainty about which economic groups actually bear the burden of the taxes paid by the CNMI and U.S. garment industries. Garment manufacturers may shift some or all of their tax burden to others, and data limitations prevent a reliable estimate of the extent of this shifting.

16. We have added a note to table 4 indicating that we included the employer's share of Social Security taxes in our calculation of taxes paid by U.S. garment manufacturers. Accordingly, it is appropriate to also include them in calculating taxes paid by the CNMI garment industry. We disagree that the nonresident worker fee should be excluded when comparing the taxes paid by the garment industries in the CNMI and in the United States. The Department states that we should exclude that fee because we do not include fees that U.S. garment manufacturers pay to employment services. However, the former is a tax paid to the CNMI government by garment manufacturers who hire foreign workers and is correctly included in the total taxes and fees paid by the CNMI garment industry, while the latter is not a tax paid by the U.S. garment industry and is correctly excluded.

17. As discussed in comment 15, we did not address the question of the tax burden borne by the CNMI garment industry. However, in comments 14 and 16, we explain why it is appropriate to include the user fee, the employer's

share of Social Security taxes, and the nonresident worker fee in calculating the taxes paid by the garment industry in the CNMI.

18. We believe that the CNMI economy and its local resident population have benefited from the economic growth in the past 20 years. That growth has been driven by the garment and tourist industries and the use of foreign workers. In terms of future growth—as discussed in comment 4–we agree with the Department that the long-term prospects for the economy are a concern. The report states that the CNMI's reliance on the garment and tourist industries and on foreign workers makes it vulnerable to outside events that affect either industry or the economy's access to foreign workers.

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